A Separate Personal Income Tax for Ontario: An Ontario Economic Council Position Paper

Ontario Economic Council
Special Research Report

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Ontario Economic Council
81 Wellesley Street East
Toronto, Ontario
M4Y 1H6

Printed in Canada

ISSN 0225-591X
ISBN 0-7743-8053-5

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Ontario
Economic
Council

81 Wellesley Street East
Toronto, Ontario
M4Y 1H6
(416) 965-2328

March 7, 1983

The Honourable Frank S. Miller
Treasurer of Ontario and
Minister of Economics
The Frost Building South
7th Floor, Queen's Park
Toronto, Ontario
M7A 1Y7

Dear Mr. Treasurer:

On behalf of the Ontario Economic Council, I am pleased to transmit to you our report on the Personal Income Tax Reference. I am also pleased to advise you that the report has unanimous Council endorsement.

Respectfully,

Thomas J. Courchene

Thomas J. Courchene
Chairman

MEMBERS OF THE ONTARIO ECONOMIC COUNCIL

Thomas J. Courchene

Thomas J. Courchene, Chairman

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Seafarers' Training Institute

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†E. Gérard Docquier
National Director
United Steelworkers of America

John Grant
Director & Chief Economist
Wood Gundy Limited

††William A. Jones
Secretary-Treasurer
Ontario Teachers' Federation

†Mr. Docquier has been appointed to the Royal Commission on the Economic Union and Development Prospects for Canada. In order to avoid a potential conflict of interest, Mr. Docquier did not participate in the deliberations leading to this report.

††Members of the PIT Steering Committee.

Robert W. Korthals
President
Toronto Dominion Bank

Samuel A. Martin
Professor
School of Business Administration
University of Western Ontario

Clifford G. Pilkey
President
Ontario Federation of Labour

Murray Rumack
Partner
Clarkson Gordon

Clayton M. Switzer
Dean of Agriculture
University of Guelph

††David M. Winch
Professor
Economics Department
McMaster University

William Mackness
Vice-President and Economic Advisor
The Bank of Nova Scotia

††Elizabeth Parr-Johnston
Corporate Strategies
Shell Canada Limited

Bruno R. Rubess
President
Volkswagon Canada Inc.

††David C. Smith
Deputy Chairman
Ontario Economic Council
Economics Department
Queen's University

Donald J. Taylor
Senior Vice-President and Director
Shell Canada Limited

††Members of the PIT Steering Committee.

Ontario

Office of the
Treasurer
of Ontario

Ministry of
Treasury and
Economics

Frost Buildi
Queen's Par
Toronto, Ont
416 965-636

June 9, 1982

Dr. Thomas J. Courchene
Chairman
Ontario Economic Council
81 Wellesley St. E.
Toronto, Ontario
M4Y 1H6

Dear Dr. Courchene:

In the 1982 Ontario Budget, which I presented to the Legislature on May 13, I emphasized my concern about recent developments in Canadian income tax policy and expressed my intent to examine our tax system to assess the potential problem of participating in an income tax system which may not be suitable to the economic needs of Ontario. To augment our own process of review, I would like the OEC to undertake a reference for my ministry. I would ask the Council to investigate and report upon the following question: "What would be the economic implications if the Province of Ontario were to withdraw from the present Tax Collection Agreement with the federal government and institute its own personal income tax collection system?"

In conducting its review, the Council should assume that the purpose of such a change would be to enhance the ability of the Government of Ontario to pursue economic objectives and to meet the needs of the residents of the province efficiently.

Among the questions I wish the Council to consider are:

1. Does the Ontario personal income tax structure have sufficient weight to influence economic activity and to allow for the conduct of independent stabilization policy or introduction of effective sector-specific tax actions?

2. What are the potential advantages and disadvantages for Ontario of flexibility for separate personal income tax policies with respect to:

    - the encouragement of work effort, personal savings and the reallocation of investment;
    - interprovincial tax barriers and jurisdictional tax competition; and
    - federal-provincial relations?

....2

3. What are the estimated net changes in administrative costs?

4. What are the estimated net changes in compliance costs?

It is understood that the Council's work on this reference would be carried out independently, would be financed separately so as not to encroach on the Council's research and administration budget and would be made available to the public without modification or delay after its transmittal to me.

Yours sincerely,

Frank Miller

Frank S. Miller
Treasurer of Ontario

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ACKNOWLEDGEMENTS

This report, drafted by our Chairman, Thomas J. Courchene, constitutes our response to the Ontario Treasurer's Reference requesting us to examine the economic implications that would attend a decision by the province to withdraw from the Tax Collection Agreements and institute its own collection system for the personal income tax. As indicated in the Letter of Transmittal, the report has the unanimous endorsement of the Council.

Upon receiving the Treasurer's Reference in June of 1982, we appointed Professor Douglas Hartle of the University of Toronto project Research Director. Professor Hartle's role was twofold—first, to assemble a research team that would bring to light the descriptive and analytical material needed to assess the overall question of an independent PIT for Ontario and, second, to incorporate this background material in a separate volume. This volume, *A Separate Personal Income Tax for Ontario: An Economic Analysis*, edited by Dr. Hartle, is being published shortly. While the views in this background study (as we shall refer to it hereafter) are those of Dr. Hartle and his collaborators, and not necessarily those of the Council, it has provided the basic building blocks for our own report. We wish to express our gratitude to Professor Hartle for coordinating and overseeing this challenging task.

In addition, the Ontario Economic Council will publish a third volume relating to the reference. This will be edited by our Research Director, David W. Conklin, and will be entitled *A Separate Personal Income Tax for Ontario: Background Studies*. It will contain some of the many background documents that were prepared in connection with the Reference. A list of the contributors to the overall research effort appears at the end of the present volume.

The Council also expresses sincere appreciation to its staff for the many hours that they devoted to this project (Research Director David Conklin, Administrative Officer Sharon Wahl, Ann Chin, Nancy Cole, Doug Crocker, Tom Gerylo, Brenda Huff, Nancy Savoie, Aly Sy, and Sandra Tychsen). Thanks are also due to Charlotte David of Queen's University for typing the initial drafts of this report.

Finally, we are very appreciative of the cooperation we have received from all quarters in connection with this Reference. Treasury and finance officials from all provinces as well as the federal government cooperated fully. We are also grateful to several individuals for both their encouragement and their comments on earlier drafts of this Report.

The Ontario Economic Council

Foreword

INTERPRETING THE NATURE OF THE REFERENCE

Since the conclusion of the income tax reform exercise of the early 1970s, Ontario and the federal government have had a basically harmonious relationship in the field of income taxation. Ottawa integrated Ontario's property and sales tax credit program into federal administration. Ontario has been supportive of most of the federal government's policies for personal income tax levels, incentives, and tax administration. In fact, over the decade preceding the 1981 federal budget, the personal income tax stood as an example of how the two levels of government could cooperate effectively in the administration of a highly complex tax field which directly affects the life of virtually every Canadian.[1]

Indeed, one can go further than this. Canada has one of the most decentralized federations in the world. Moreover, in terms of the proportion of income tax revenues, both personal and corporate, that accrues to the provincial governments, Canada has one of the more decentralized income tax systems in the world. Yet we have succeeded in maintaining a degree of coordination and harmonization in the income tax field that is the envy of other federations. This degree of integration and harmony is a remarkable achievement in light of the fact that scarcely forty years ago the Rowell-Sirois Commission called the highly uncoordinated, allocatively inefficient, and openly beggar-thy-neighbour approach to income taxation that prevailed during the depression a veritable 'tax jungle'.

Despite these developments, many provinces are now expressing concern about the present set of arrangements relating to personal and corporate income taxation. Alberta has withdrawn from the Tax Collection Agreements for corporation taxation and, like Quebec and Ontario, has developed its own system of corporate income taxation. The two westernmost provinces have made preliminary moves in the direction of establishing their own, separate personal income tax systems. And in his May 13, 1982 budget, the Treasurer of Ontario expressed his intent 'to examine our tax system to assess the potential problem of participating in a personal income tax system which may not be suitable to the economic needs of Ontario'.[2] This concern led directly to the Treasurer's Reference to the Ontario Economic Council and to the central thrust of the Reference:

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[1] Ministry of Treasury and Economics, *Ontario Tax Structure: Options for Change: A Discussion Paper* (Toronto: Queen's Park, 1982), 25. This publication will be referred to hereafter as the Treasury discussion paper.

> What would be the economic implications if the Province of Ontario were to withdraw from the present Tax Collection Agreement with the federal government and institute its own personal income tax collection system?[3]

On the surface, this might appear to be a very narrow or 'provincial' Reference. However, among the specific issues that the Council has been asked to address are the implications of a separate Ontario personal income tax with respect to 'interprovincial tax barriers', 'jurisdictional tax competition', and 'federal-provincial relations'. These considerations add a 'Canadian' dimension, as it were, to the Reference.

The Ontario Economic Council recognizes fully this larger dimension of the Reference. We shall indeed examine the benefits and costs of Ontario 'going it alone' on the personal income tax (PIT) front. In doing so, however, we shall be assessing these benefits and costs from more than one vantage point. The obvious first frame of reference relates to the implications that a separate Ontario PIT would have for the economic wellbeing of Ontarians. A second frame of reference relates to the implications of a separate Ontario PIT for other provincial governments and their residents. This issue involves an assessment of Ontario's economic and financial links with the other provinces in the federation. More importantly, it is intricately bound up with the notion of an internal common market or a Canadian economic union. These terms will be defined later. Suffice it to say at this juncture that they relate to the degree to which persons, goods, services, and capital can move free and freely across provincial boundaries. As will become evident as the report proceeds, the Council places a great deal of emphasis on the preservation of an internal common market. A final vantage point relates to the effects a separate PIT might have on the central government's ability to meet its own fiscal responsibilities in such areas as income distribution and economic stabilization.

In other words, this is an Ontario document in the sense that the Council's responsibility is to the people of Ontario. However, it is also a document about Canada both because Ontarians are, first and foremost, citizens of Canada and because a separate Ontario PIT has implications that transcend those related to Ontario's own residents.

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[2] Reproduced in the letter from the Treasurer of Ontario to T.J. Courchene attached as the terms of reference at the beginning of this report.

[3] *Ibid.*

In his Reference to the Council, the Treasurer states that, when it focusses on the costs and benefits of an Ontario-run PIT, 'the Council should assume that the purpose of such a change would be to enhance the ability of the Government of Ontario to pursue economic objectives and to meet the needs of the residents of the province efficiently.'[4] Granted that we accept this as an overall motive, it is nonetheless necessary to become more specific. Why would a province want to opt for its own PIT? In addressing this issue it is convenient to fall back on some of the concerns respecting the existing arrangements aired by the Ontario Treasury in its background position paper. In doing so it is essential to recognize that the background paper was 'presented for discussion and does not reflect the Government's policy at this time.' What follows are several possible rationales for a provincially run PIT. They are put forward basically without evaluation, since the task of the remainder of the document is to conduct just such an evaluation.

1. *A given province may have an economic structure different from those of other provinces and hence may require a separate PIT structure.*

   Ontario's case with respect to this rationale would presumably be, in part, that it is the home of much, if not most, of the country's secondary manufacturing and the principal financial centre of the nation. Since these industries are highly mobile, it is imperative that the personal income tax structure be in tune with the needs of the underlying industrial structure. This might mean that it is more important for the overall PIT facing Ontarians to be closer to that facing northeastern Americans than to that facing western Canadians, since the northeastern U.S. is often the likely alternative location for its industries. Even though Ontario would control only one-third of the overall income tax, this would provide the province with sufficient leverage to tailor the overall tax to its structural needs, or so the argument would go.

2. *A separate PIT would provide a province with a more predictable and independent revenue base.*

   Experience with the revenue guarantee (discussed in Chapter 1), the 1982 Fiscal Arrangements Act, and numerous recent federal tax changes which unilaterally affect a province's flow of PIT revenues might provide a case for going it alone in terms of developing and maintaining a stable and predictable personal income tax base.

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[4] *Ibid.*

3. *A separate PIT would mean that a province would not have to parallel those features of federal personal income tax changes that it felt were detrimental to the best interests of its residents.*

   It is worth discussing this rationale at some length, since it probably played a role in the Treasurer's decision to refer the issue to the Council. It is matter of record that the government of Ontario was very concerned with some of the details in the November 1981 federal budget as they related to the taxation of personal income:

   > Ontario was concerned about several personal income tax proposals. Specifically, the restricted deductibility of interest expenses related to investment will discourage individuals from risk taking. The replacement of the previous income-averaging provisions with limited forward averaging, including prepayment of taxes at the top marginal rates, will impact severely on taxpayers with irregular or cyclical income receipts, such as farmers and small businessmen. This group is further affected by the restrictions on the reserve provisions available to ease the tax burden on capital gains resulting from the sale of a farm or business. The capacity for tax-free rollover of retirement and termination benefits has been significantly reduced. Finally, investment income accrued in annuities and life insurance policies will be taxable every three years rather than at maturity, thereby requiring taxpayers to pay tax on income that usually will not be received for a number of years.[5]

The Treasury background document goes on to note:

> In the area of *corporate income taxation*, Ontario has at least one course open if its views are not heeded in Ottawa. Since the Province administers its own corporate income tax, *it need not parallel federal policies* and thus does not have to burden corporations with inappropriate taxation policies. However, *current arrangements with respect to the personal income tax compel Ontario to parallel federal measures* even though they may not be in the best interest of the people of Ontario. Not only may Ontario be an unwilling partner in policies it feels are misguided, but it actually *magnifies* their impact simply by virtue of sharing the common tax base.[6]

Two comments are appropriate here. First, Ontario *did not* parallel the recent federal initiatives affecting the corporate income tax. Second, the last sentence of the quote refers to the circumstance that although the federal government receives only two-thirds of total personal income tax revenues, the fact that Ontario must accede to any changes means that Ottawa's tax changes automatically affect Ontario's share of PIT revenues as well i.e., the changes are 'magnified', to use the Treasurer's term.

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[5] Treasury background document, 25.

[6] *Ibid*. Emphasis added.

4. *A separate PIT might increase the degree of consultation before major federal tax changes.*

   This is related to the above rationale. A case might be made that if Ontario had its own PIT with its own tax structure (including the definition of what constitutes income, etc.) the federal government would be more willing to entertain consultation prior to major tax changes in order to miminize the degree of difference between the federal and provincial tax structures. Several provinces have voiced concern over the apparent lack of consultation under the present system.

5. *A separate provincial PIT might have an influence on the structure of personal income taxation at the federal level.*

   This is the so-called 'demonstration effect'. Much has been written about the manner in which a range of federal social programs have been influenced by previous experimentation at the provincial level, especially in Saskatchewan. So might it be with personal income taxes. For example, the Treasury discussion paper focussed on the following specific concerns relating to the treatment of investors and investment income:

   > A separate income tax system would give Ontario flexibility to determine the suitable tax treatment of interest expenses, capital gains reserves, and the treatment of capital gains income. For example, it would be possible to examine the option of indexing the cost base for capital gains, or to treat truly speculative gains differently from more productive investment gains. It would also be feasible to consider the entirely separate tax treatment of investment income under a distinct rate schedule. Other specific measures, such as a stock savings plan, could be reviewed to determine whether they would productively create investment and jobs in Ontario.[7]

   It is conceivable that modifications made by Ontario in, say, the definition of taxable income would be incorporated into the federal tax structure as well. Currently, this avenue is open only to the extent that the process of consultation is also open.

6. *A separate provincial PIT would give a province complete freedom to determine the progressivity of its own income tax and, therefore, considerable ability to determine the progressivity of the overall personal income tax.*

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[7] *Ibid.*, 27.

While there is considerable truth to this proposition, it is appropriate to note that the PIT is only one of the many government instruments that affect the distribution of income.

7. *The system of tax credits gives the provinces some power within the overall PIT to influence income distribution. However, provincial concern currently appears to be related more to investment incentives and sector-specific aid. Such measures often run counter to the goal of maintaining an internal common market, and consequently tax credits based on these objectives are likely to be rejected by Ottawa.*

   A separate PIT may be a way out of this dilemma. Quebec, which has its own PIT, has introduced investment-oriented measures that other provinces have attempted to replicate, only to have their proposals rejected by the federal government as being inconsistent with the spirit of the tax collection agreements.

8. *A separate PIT is necessary as the backbone of an integrated socioeconomic program.*

   A province might want to integrate such things as family allowances, welfare, payroll taxes, and transfers to municipalities within a single overarching tax-transfer program, the centrepiece of which would be the provincial PIT.

9. *A separate PIT is essential for symbolic and constitutional reasons.*

   This may have been part of the rationale for Quebec's move to a separate PIT in the early 1950s.

These various arguments are meant to be illustrative rather than exhaustive. In the following chapters the analysis will not be directed explicitly to these propositions, but in one way or another the issues they embody will be addressed and evaluated.

OUTLINE OF THE REPORT

Part I of our report focusses on the past and present state of personal income tax in Canada and more particularly in Ontario. Chapter 1 outlines the current Ontario-Ottawa relationships with respect to the PIT. Chapter 2 traces the major historical trends associated with the evolution of the income tax system in our federation. The second part of the chapter deals with the tax credit system and in particular with the recent provincial concerns relating to the operations of the PIT. Chapter 3 discusses the origin and subsequent development of the Quebec income tax system. Reviewing the Quebec experience may provide valuable insights as to the likely workings of a separate Ontario PIT. The final chapter of Part I focusses on

Ontario's experience with operating its corporate income tax system. The role of this chapter is, by analogy, to shed light on the likely degree to which an Ontario-run PIT would depart over time from the federal PIT in terms of such things as the definition of income and of allowable exemptions. Concluding Part I, and most of the other parts as well, is a series of Council Observations, which serve to both summarize and highlight the main text.

With Part II, which focusses on the growth and efficiency implications of a separate PIT, we begin the analysis of the costs and benefits of an Ontario PIT. It is at once probably the most difficult and most important section of the report. The section begins with the development of an analytical framework in Chapter 5. Following this framework are chapters that deal, in turn, with savings, investment, new ventures, and human capital considerations. Throughout the analysis, the focus is on the potential benefits that can be derived from a separate PIT and on the question whether these benefits can be delivered by policy instruments other than the PIT.

Part III focusses on the stabilization implications and Part IV on the distributional implications of an Ontario-run PIT. Part V deals with what we refer to as the integration aspects of an Ontario PIT, i.e., the potential role of a PIT as the centrepiece of a delivery system for a comprehensive tax-transfer program to citizens. This PIT-centred system could include family allowances, welfare, payroll taxes, and municipal revenues.

With Part VI, the focus of the analysis becomes more general. The concern here is with the implications for Canadian federalism of a move by Ontario to adopt an independent PIT. Issues such as interprovincial tax harmonization or coordination and the role for provincial PIT strategies are highlighted within the context of an economic theory of federalism. Particular emphasis is placed on the interrelationship between provincial PITs and the efficient functioning of a domestic common market.

Part VII then attempts to provide some estimates of the administration and compliance costs of a separate Ontario PIT.

The final substantive section deals with the political benefits and costs of a separate Ontario PIT. The former relates to the stream of potential benefits that the province could deal out in the form of PIT-related measures. The latter include, for example, the costs associated with the existence of lobbyists and others who would recognize that part of the PIT action was now located in Queen's Park.

Part IX is a summing-up of the potential benefits and costs of a separate PIT. Included in this section is an analysis of the several alternative approaches and opportunities that lie between the extremes of the *status quo* and an independent PIT.

Part X contains the Council's conclusions (Chapter 20) and recommendations (Chapter 21).

PART I

Personal Income Taxation in Canada: Past and Present

1
The PIT in action: 1982

AN OVERVIEW OF THE PRESENT SYSTEM

The personal income tax system in Canada is shared between the federal government and the provinces. (This description excludes Quebec, which has its own independent personal income tax system.) The arrangements under which the system exists are known as the Tax Collection Agreements, which were inaugurated in 1962. Under these agreements, the federal government collects the taxes for both levels of government. Employers make only one deduction from source income, and taxpayers see only one deduction for income tax on their tax stubs, fill in only one tax return, and make out only one income tax cheque (or receive only a combined refund). The entire administrative cost of both the collection and audit processes is borne by Ottawa.

Not surprisingly, there is also a cost to the provinces. The nine participating provinces must accept the federal structure for income taxation. Under the current arrangements, the federal government defines virtually all aspects of the income tax structure, including

—the types of income subject to tax,
—the exemptions and deductions from income, and
—the underlying marginal rates, the bracket size, and the indexation factors.

The provinces are not allowed to alter these aspects of the tax structure. In addition, they are required to accept, usually without prior knowledge let alone consultation, any and all federal modifications.

However, the provinces are not entirely in a straitjacket. They can influence the overall tax structure in two ways. First, they can set their own tax rates—tax rates that are applied to 'basic federal tax', as will be outlined below. Currently, Ontario's tax rate is 48 per cent of basic federal tax. Second, provinces can institute various tax credits. These tax credits must receive federal approval, which means in effect that they must satisfy three criteria:

1. the tax credits must be administratively feasible,

2. they must not alter the harmony of the overall tax system, and
3. they must not jeopardize the efficient functioning of the Canadian economic system.

Ontario currently provides property tax credits, sales tax credits, political contribution credits, and, as a result of the dramatic energy price rise, temporary home heating credits. Chapter 2 will discuss the development and role of tax credits in detail. For present purposes, it is sufficient to note that the federal government administers and, for a fee, collects these credits on behalf of the province. Up to a certain value per capita of the credits, the fee is 1 per cent of the credits. The percentage declines as the value per capita of the credits increases.

THE PROVINCIAL INCOME TAX IN ACTION

Table 1 presents data relating to the contribution of personal income taxes to Ontario revenues. In recent fiscal years, personal income taxes have accounted for over two-fifths of Ontario's total own-source revenues. The rise in income taxes as a proportion of total revenues between 1980-81 and 1981-82 reflects the rise in the Ontario tax rate from 44 per cent to 48 per cent. It is interesting to note that this tax rate increase represents the *first* discretionary tax increase initiated by the province since the inception of the tax collection agreements in 1962. There have been other increases in the provincial rate over this period, but they have all been associated with the transfer of income tax room from the federal government to the provinces. This vacating of tax room works as follows: Ottawa reduces its tax take and, therefore, reduces basic federal tax, and the provinces increase their tax rates in order to take up the transferred share of taxes. In these circumstances, the citizen's total income tax bill is *unchanged*—a larger share is now allocated to the provinces and less to the federal government, but the overall amount remains the same.

Table 2 focusses on the progressivity of the Ontario portion of the personal income tax. For categories of gross income under $20,000, the percentage of total taxpayers in each income category is larger than the percentage of total revenues raised from this income category; the reverse is true for gross income levels above $20,000. For example, 26.6 per cent of taxpayers fell into the $10,000-15,000 range in 1979. Their tax payments accounted for 14.4 per cent of total income tax revenues. Just over 10 per cent of taxpayers earned between $25,000 and $35,000, but their tax contributions amounted to nearly 20 per cent of total PIT revenues. In this sense, the personal income tax can be said to be a 'progressive' tax.

It is important to recognize that the overall degree of progressivity is largely determined by the federal level, since it alone has the right to determine the tax structure (i.e., the width of tax brackets and the progressive rate structure). As

TABLE 1
Contribution of the personal income tax to Ontario tax revenues

	Personal income tax revenue[a]	Total tax revenue[a]	PIT as a percentage of total revenue
	($ million)	($ million)	(%)
1977-78	2,477	6,653	37.2
1978-79	2,735	6,947	39.6
1979-80	3,183	8,558	37.2
1980-81	3,578	9,449	37.9
1981-82[b]	4,928	11,132	44.3
1982-83[b]	5,584	12,576	44.4

[a] Tax revenue is net of Ontario tax credits.

[b] Interim figures for 1981-82 and estimates for 1982-83 reflect increases in the Ontario personal income tax rate. In addition, the replacement of Ontario tax credits with direct tax grants for senior citizens has had the effect of increasing the relative importance of personal income tax revenue.

SOURCE: Ontario Treasury.

TABLE 2
Distribution of taxpayers by income class and Ontario income tax paid, 1979

Gross income	Taxpayers	Cumulative distribution	Ontario income tax	Cumulative distribution
($)	(%)	(%)	(%)	(%)
less than 5,000	0.8	0.8	0.1	0.1
5,000-10,000	22.9	23.7	5.8	5.9
10,000-15,000	26.6	50.3	14.4	20.3
15,000-20,000	21.1	71.4	19.2	39.5
20,000-25,000	13.3	84.7	17.4	56.9
25,000-35,000	10.1	94.8	19.2	76.1
35,000-50,000	3.3	98.1	9.8	85.9
50,000-75,000	1.2	99.3	5.5	91.4
75,000-100,000	0.3	99.6	2.7	94.1
100,000 and above	0.3	100.0	6.0	100.0
	100.0		100.0	

NOTE: Totals may not add due to rounding.

SOURCE: Ontario Treasury.

noted above, a province is allowed to set a *single* tax rate (48 per cent in Ontario's case) to apply to basic federal tax. Obviously, an increase in this single tax rate increases average tax rates, but not so obviously it also increases marginal tax rates for all taxpayers, as is evident from Table 3.

TABLE 3
Provincial income tax rates, 1982

		Combined federal-provincial marginal tax rates[d]		
Province	Tax rate	$10,000 taxable income[a]	$35,000 taxable income[b]	Maximum tax rate[c]
Newfoundland	59.0	30.2	47.7	54.06
P.E.I.	52.5	29.0	45.7	51.85
Nova Scotia	56.5	29.7	46.9	53.21
New Brunswick	55.5	29.5	46.6	52.87
Ontario	48.0	28.1	44.4	50.32
Manitoba	54.0	29.3	46.2	52.36
Saskatchewan	51.0	28.7	45.4	51.34
Alberta	38.5	26.3	41.5	47.09
British Columbia	44.0	27.4	43.2	48.96

[a] Federal marginal rate equals 19 per cent.

[b] Federal marginal rate is 30 per cent.

[c] Maximum federal rate for 1982 is 34 per cent for taxable income in excess of roughly $61,000.

[d] Combined marginal rates equal the federal rate plus the product of the two rates.

NOTE: These marginal rates do not take the various provincial surcharges into account. With surcharges, the maximum rates would obtain as follows: Manitoba—56.03 per cent; Saskatchewan—53.42 per cent; B.C.—50.46 per cent. Corresponding percentages for the three provinces for the $35,000 column would be 49.4, 46.4, and 43.5 respectively.

Provincial tax rates vary considerably across provinces, from a high of 59 per cent in Newfoundland to a low of 38.5 per cent in Alberta. These provincial tax rates appear as the first column of Table 3. Also included in this table are estimates of the effective *overall* (federal plus provincial) marginal rates across provinces for three selected net income levels. These figures take account of the November 1981 federal budget, which lowered federal marginal rates to ensure, on average, that the maximum combined federal-provincial marginal rate would not exceed 50 per cent. They do not take account of the surcharges imposed by some provinces on incomes above a certain level. However, the note to Table 3 presents, for the maximum tax rate column, the impact of such surcharges. Data for Quebec are not presented in Table 3. The combined 1982 marginal rates for Quebec taxpayers for the three income classes of the table are 37.2 per cent, 53.1 per cent, and 60.40 per cent.

On average, the provinces account for roughly one-third of income tax revenues and the federal government for two-thirds. For example, a 50 per cent provincial income tax would imply that the province's share of the total tax would be one-half of the basic federal tax, for an overall proportion of one-third.

THE STRUCTURE OF THE PIT

In order to provide a fuller appreciation of the operations of the current PIT, Table 4 outlines briefly the steps that a taxpayer goes through in filling out a tax form, identifying those steps that fall under federal jurisdiction, those under provincial control, and those for which responsibility is shared.

Items 1 through 6 in Table 4 (i.e., the definition of income, the allowable deductions, personal exemptions, and the underlying progressive rate structure) are entirely under federal control. Thus, any changes in these definitions or regulations will *automatically* affect provincial revenues. The provinces are required to accept these changes. For their part, the provinces have control over their own tax rate (item 7) and over the provincial tax credits (item 9). Nonetheless, it is clear that provincial taxes payable (item 10) are jointly determined. Excluded from the table proper are federal tax credits (e.g., political contribution credits), which will reduce the taxpayer's federal tax liability. These credits occur below the line, as it were (i.e., after the calculation of basic federal tax), so that they do not affect provincial taxes payable.

'TAX ON TAX' OR 'TAX ON BASE'

Table 4 provides a very convenient framework for introducing a concept that will become important as this report progresses. Since the provinces are restricted to applying their tax rates to 'basic federal tax', this system is often referred to as a 'tax on tax' system, i.e., the provinces are in effect levying a tax on federal tax payable. One obvious alternative would be to allow the provinces to apply their tax rate (or tax rates, as would likely be the case) to 'taxable income'—i.e., item 4 in Table 4—just as the federal government applies its rate and bracket structure to taxable income. Such an arrangement is usually referred to as 'tax on base' or 'tax on income'. This approach will be dealt with in more detail later.

CONCLUSIONS

This, then, has been a brief overview of major characteristics of the operations of the 1982 personal income tax system as it applies to the nine provinces that remain signatories to the Tax Collection Agreements. The next chapter traces the history of the PIT in Canada. In order to understand fully where matters stand today and the implications of any possible modifications, the Council believes that it is essential to appreciate where we have been, PIT-wise, over the years. To this we now turn.

TABLE 4

A schematic approach to the operation of the personal income tax

Conceptual step	Elaboration	Jurisdiction
1. DEFINITION OF INCOME	e.g., employment income, business income, capital gains, investment income	federal
subtract:		
2. ALLOWABLE DEDUCTIONS	e.g., RRSPs, pension contributions, UI contributions,	federal
union dues		
subtract:		
3. PERSONAL EXEMPTIONS	e.g., spouse exemptions, child allowance, charitable deductions	federal
equals		
4. TAXABLE INCOME		federal
multiplied by		
5. FEDERAL MARGINAL RATE SCHEDULE	tax brackets indexed each year	federal
equals		
6. BASIC FEDERAL TAX		federal
multiplied by		
7. PROVINCIAL RATE OF TAX ON BASIC FEDERAL TAX	must be a single percentage (e.g., 48% for Ontario); applied to 'basic federal tax'	provincial
equals		
8. PROVINCIAL TAX PAYABLE BEFORE CREDITS		a product of 6 (federal) and 7 (provincial), so controlled by both levels
less		
9. PROVINCIAL TAX CREDITS	e.g., property tax credits, political contribution credits, tax surcharges or reductions	provincial
equals		
10. PROVINCIAL TAXES PAYABLE		obviously, jointly determined.

NOTE: Federal tax credits which appear *after* the calculation of basic federal tax (item 6 in the table) do not affect provincial revenues. These can range from general tax credits to specific (e.g., political contribution) tax credits.

2

A historical perspective on the evolution of the PIT

Tracing the history of the federal-provincial tug-of-war over the operations of the personal income tax is not all that different from reviewing the history of the federation itself. Earlier we remarked that although Canada is one of the most decentralized of federal states it has nonetheless achieved a rather remarkable degree of harmony in its system of taxation. In this chapter it will become clear that this degree of tax harmonization did not come easily. The story of the evolution of the PIT from the BNA Act through to the Constitution Act, 1982, is a story of constant federal-provincial struggle and negotiation. If one can point with some degree of satisfaction to the present taxation arrangements in Canada, it is a testament more to the statesmanship of our federal and provincial forefathers than to any automatic or natural process.

The first section of this chapter will review some of the historical developments that underlie the current PIT arrangements. Unfortunately, the nature of our report limits us to focussing only selectively, and then but sketchily, on this most fascinating and exciting history. The second substantive section of the chapter is devoted to one aspect of the more recent history of the PIT that has taken on major significance—the development of provincial income tax credits that are administered by the federal government within the Tax Collection Agreements. The final section of the chapter is devoted to the current impasse. Of necessity our principal focus will be on likely future developments with respect to the personal income tax. But the strains now manifesting themselves with respect to the operations of the PIT are reflective of a more general malaise that attends federal-provincial financial relations. We shall have some recommendations relating to all of this, but they will appear in the concluding section of the volume.

A BRIEF HISTORY OF THE PIT

Table 5 contains a blow-by-blow account, as it were, of the evolution of personal income taxation in Canada.[1] We make no claim that the table is in any way exhaustive, particularly since it focusses much more on Ontario than on other provinces. The table is intended to be self-contained in the sense that much of the task of working through these events is left to the reader.

However, the broad trends are clear enough. Beginning as a levy by the municipalities, the personal income tax was next taken up by some of the provinces and finally, during the First World War, by the federal government. Strapped by a fall in revenues brought on by the Depression and by rising socio-economic responsibilities, all levels of government intensified their PIT activities during the 1930s. The Wartime Tax Agreements centralized the PIT in federal hands, and on the heels of the 1945 White Paper on Employment and Income the federal government mounted a spirited campaign to retain control of direct taxation, arguing in part that it needed such control in order to realize important (Keynesian) macroeconomic or stabilization objectives. To some extent this attempt succeeded. However, the story of the post-war period is essentially one of the provinces steadily regaining control over direct taxation. With the three largest provinces that remain signatories to the Tax Collection Agreements all moving recently in the direction of 'going it alone', matters appear to be coming to a head. Now to some selected highlights of this historical evaluation.

The Rowell-Sirois Report

We cannot delve into the myriad of insights and recommendations contained in the Rowell-Sirois Report. However, it is instructive to provide some flavour of the manner in which the 'uncoordinated efforts of all governments to maintain solvency were reducing the tax system to chaos':[2]

> Both the federal and provincial governments attempted to prevent revenues from declining during the Depression by increasing taxes. The federal government increased its sales tax from 1 per cent to 8 per cent, doubled the personal income tax, and imposed new import duties. The provinces increased the gasoline sales tax by 50 per cent and raised succession duties and flat-rate taxes on corporations. By 1940, all (or virtually all) provinces were

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[1] These episodes are drawn from the background document and also from a forthcoming OEC study by Thomas J. Courchene, *Equalization Payments: Past, Present and Future*, particularly Chapter 4, 'The Evolution of Equalization Payments: The BNA Act to the Constitution Act, 1982', Discussion Paper 510, Institute for Economic Research, Queen's University, 1983.

[2] Milton Moore, J. Harvey Perry and Donald I. Beach, *The Financing of Confederation: The First Hundred Years* (Toronto: Canadian Tax Foundation, 1966), 10.

TABLE 5

A selective chronology of personal income tax developments

Year	Development	Comments
1851	Ontario municipalities begin collecting personal income taxes.	The collection of PIT by Ontario municipalities continues right through to 1936.
1867	BNA Act.	The federal government is assigned power to raise money 'by any mode or system of taxation'. Provinces are restricted to levying direct taxes.
1876	British Columbia introduces a PIT.	British Columbia is the first province to adopt a PIT.
1894	Prince Edward Island establishes its own PIT.	
1917	Federal government introduces its own PIT.	Challenges prevailing wisdom that the PIT is the exclusive domain of the provinces. The Minister of Finance, Thomas White, reflects this sentiment even as he introduces the tax: 'the income tax is peculiarly within the jurisdiction of the province and is a suitable tax for purposes of the province and the municipality. In my opinion, the federal government should not resort to an income tax until it is indispensably necessary in the national interest that it do so.'
1922	Privy Council rules in Caron v. R that federal government has the right to levy PIT.	Federal PIT activities challenged by a Quebec cabinet minister. The court confirms that the BNA Act envisaged joint occupancy of the direct taxation field.
1923	Manitoba establishes its own PIT.	
1932	Saskatchewan and Alberta introduce their own PITs.	Part of the scramble for revenue in the 1930s that contributes to the field of taxation in Canada becoming a 'tax jungle'.
1936	Ontario introduces its own PIT. At the same time, it concludes an agreement with Ottawa whereby the Department of National Revenue would administer and collect the tax. Hence, it is not really an 'Ontario run' PIT.	Comment by Premier Hepburn: 'This Act [the Income Tax Act] replaced the disgraceful checkerboard system of municipal income tax, full of inequalities, anomalies and hardships.

TABLE 5, continued

Year	Development	Comments
1938	Manitoba and Prince Edward Island follow the Ontario (1936) model.	
1939	Quebec introduces a PIT on the Ontario model.	
1940	*Report of the Royal Commission on Dominion Provincial Relations* (Rowell-Sirois Report).	Proposals to restructure federal-provincial financial relations. As part of an overall program, the Report recommends that the provinces transfer direct taxation (including PIT) to the federal level.
1941	Conference on the Rowell-Sirois Report.	Provinces reject Rowell-Sirois proposals.
1941	Wartime Tax Agreements (to be in force from 1942-47). This is the first of several agreements that are commonly referred to as 'tax rental' arrangements.	Exigencies of wartime finance lead to provinces' 'renting' personal income taxation to the federal government. Comment by R.M. Burns: 'Patriotism accomplished what financial reasoning could not.' In return for the rental agreement, the provinces have the choice of: (a) the revenue yield within the province in 1941 from the vacated tax field (selected by Que., Ont., Man., Alberta, and B.C.); (b) the net cost of servicing the provincial debt, less succession duties (adopted by Saskatchewan and the three Maritime Provinces).
1945-47	Conference on Reconstruction (1945). The Conference itself is not particularly successful. Those aspects relating to direct taxation eventually result in the 1947-52 Tax Rental Agreements.	The federal government desires to continue the tax rental arrangements for the direct taxes. It buttresses its case by invoking macroeconomic taxation (Keynesian) arguments. Three options are offered: (a) $12.75 per head plus 50 per cent of direct taxation revenue for 1940-41 plus statutory subsidies based on 1947 payments; (b) $15 per head plus the statutory subsidies; (c) $2,100,000 (this option was designed for P.E.I.). All options are to be escalated by population increase and GNP growth. Nova Scotia and Saskatchewan choose the second option. Manitoba, B.C., Alberta, and New Brunswick choose the first system. Ontario and Quebec do not sign the agreement.

TABLE 5, continued

Year	Development	Comments
1947	Ontario and Quebec set up their own corporate income taxes.	Represents the beginning of the move away from the centralization of direct taxation that began in wartime.
1950	Ontario announces a 5 per cent personal income tax.	The federal government refuses to collect it. Ontario is reluctant to put its own collection machinery in place and the tax is never brought into effect.
1952	The 1952-57 Tax Rental Agreements. Ontario signs the agreement and abandons its corporate tax. Quebec remains outside the fold.	In addition to the three options of the previous agreement (updated for 1948 levels), the federal government proposes a fourth option: the yield of the personal income tax at 5 per cent of 1948 federal rates plus the yield of 8.5 per cent on corporate profits earned in the province in 1948 plus average revenue from succession duties plus 1948 statutory subsidies. Payments are escalated as in the previous agreement. In effect, this additional option is designed to bring Ontario back into the agreements. It succeeds.
1954	Quebec establishes a separate PIT. It already has its own corporate income tax.	Establishes a rate of 15 per cent of the federal rate. Ottawa responds by establishing a 10 per cent federal tax credit for taxes paid to province. Quebecers are still 'overtaxed' by 5 per cent and face different exemptions under the two systems. Personal income taxation becomes progressively more unwieldy. The search for an alternative solution begins.
1957	The Tax Sharing Arrangements (1957-62).	If provinces opt to continue to rent the direct taxation field to Ottawa, they will receive shares of these taxes— 10 per cent of PIT, 9 per cent of corporate profits, and 50 per cent of succession duties. Alternatively, they can levy their own taxes on these sources and the federal government will provide an abatement from federal taxes equal to the above percentage. All provinces except Quebec agree for the PIT. Ontario and Quebec do not sign for corporation taxes and succession duties. Equalization program is established in order to 'equalize' the yield of these direct taxes across the various provinces.

TABLE 5, continued

Year	Development	Comments
1957	Ontario re-establishes its corporate income tax.	
1958	PIT abatement rises from 10 per cent to 13 per cent.	
1962	The Tax Collection Agreements (1962-67).	Direct taxation is once again returned to the provinces under arrangements called the Tax Collection Agreements. Provinces can levy their own tax rates and have them collected free of charge by Ottawa. They have to accept the federal definitions for such things as taxable income and exemptions. They can levy a tax on 'basic federal tax'. It has to be a single rate. This regime is still in effect today. Initially, the federal abatement is set at 16 percentage points of the personal income tax.
1962-66	Federal abatement of PIT rises from 16 percentage points to 24 percentage points by 1966.	Part of this abatement relates to the funding provisions for the Established Programs (medicare, hospital insurance, and post-secondary education).
1967	1967-72 Fiscal Arrangements. The temporary Tax Structure Committee, struck in 1964, plays an important role in federal-provincial financial relations in this era.	Continuation of 1962 agreements. PIT abatement rises to 28 per cent, which expressed as a per cent of basic federal tax (and taking into account the 1972 tax reforms) equals 30.5 per cent. This is the Ontario tax rate until 1977. Marks the end of the abatement process. Ottawa argues that if provinces want more revenue from PIT they can raise their tax rates.
1969	Ontario Treasurer McNaughton notifies Ottawa that Ontario intends to establish its own PIT within two years.	The purpose of this measure is to pressure the federal government to accept some of Ontario's views with respect to the on-going tax reform. Federal modifications, including the allowing of provincial tax credits (see 1972), eventually satisfy Ontario and the province does not proceed with its own PIT.

TABLE 5, continued

Year	Development	Comments
1972-77	1972-77 Fiscal Arrangements.	Business as usual.
1972+	PIT tax reform and introduction of the revenue guarantee.	Tax reforms include: UIC benefits taxable, increased child care exemptions, capital gains tax, increase in RRSP levels, increase in personal exemption levels. Later modifications, not part of the original reform, include the $1,000 interest income exemption, the $1,000 pension deduction, the education deduction, and elderly exemptions. In order to encourage the provinces to make parallel changes in PIT, the federal government offers the revenue guarantee (see Chapter 2).
1972	Ontario introduces the first PIT tax credit (for property taxes).	Major initiative in that it is the first of many tax credits covering the spectrum from royalty tax credits to home heating tax credits. The federal government establishes three criteria for tax credits: (1) they must be administratively feasible, (2) they must not erode the essential harmony and uniformity of federal and provincial income tax systems, and (3) they must not jeopardize the functioning of the Canadian economic union.
1973	Ottawa indexes the PIT (beginning with the 1974 taxation year). Indexation losses are not eligible for compensation under the revenue guarantee.	Provinces go along with indexing, except for Quebec.
1977	1977-82 Fiscal Arrangements. Main PIT impact relates to the block funding of the established programs and the termination of the old revenue guarantee. A temporary and weaker revenue guarantee is introduced.	As a result of refinancing the established programs, the federal government transfers an additional 9.143 personal income tax points (a tax point is 1 per cent of basic federal tax) to the provinces. For Ontario, this translates into a provincial personal income tax rate of 44 per cent.
1979	Quebec introduces its Stock Savings Plan as part of its PIT.	In computing taxable income for Quebec purposes, a Quebec resident can deduct up to $15,000 for purchases of new shares of Quebec companies.

TABLE 5, continued

Year	Development	Comments
1979	A British Columbia proposal for a tax credit along the lines of the Quebec program (1979) is rejected by the federal government as not falling within the spirit of the tax collection agreements.	Actually, the proposal covers two tax credits. One is a small business venture capital corporation tax credit (to apply to both personal and corporate taxes) and the other a dividend tax credit. Ottawa refuses to administer these credits because it views them as constituting barriers to the free flow of capital across provincial boundaries.
1979-82	Other provinces propose tax credits that Ottawa refuses to administer.	Basically, these proposals too violate the requirement that the free flow of capital across provincial boundaries be maintained. In several cases Ottawa recommends that the provinces enact these proposals as expenditure programs, i.e., not as part of the tax system. Form appears to matter more than substance.
1981	Ontario raises its personal income tax rate from 44 per cent to 48 per cent.	This represents the first increase in Ontario personal income tax rates. All previous Ontario tax increases merely took up vacated federal tax room, i.e., they did not represent an overall increase in PIT taxation.
1981	Alberta adopts its own corporate tax system.	Alberta desires a degree of flexibility in terms of incentives and innovations in its corporate tax system that may not be allowed under the Tax Collection Agreements.
1981	British Columbia serves notice to the federal government that it might withdraw from the Tax Collection Agreements unless the federal government agrees to administer its proposed dividend and venture capital tax credits.	

TABLE 5, continued

Year	Development	Comments
1982	B.C. proposes a 'Housing and Employment Bond Tax Credit'. Ottawa agrees to administer it.	This may be a very important precedent. The B.C. government will issue bonds. The interest income will *not* be taxable for provincial income tax purposes. (Ottawa refused to exempt this income for federal taxes.) The B.C. government will then lend the proceeds to eligible borrowers—individuals, corporations, and small businesses. This is a remarkable concession by the federal government, since the end result will be to erect barriers to interprovincial flows of enterprises and capital. Since the bulk of these funds was to be targetted to housing, Ottawa probably found it difficult to refuse the proposal in the face of the very high levels of interest rates.
1982	The Ontario government requests the Ontario Economic Council to evaluate the costs and benefits of a separate Ontario PIT.	

> taxing personal and corporate incomes, and Saskatchewan and Quebec had introduced a retail sales tax. There was little or no cooperation between the federal and provincial governments in taxation as both governments scrambled for revenues and produced a chaotic tax jungle of joint occupancy, high tax rates, duplication of administrative machinery, and regressiveness in taxation which contributed to the severity of the Depression by undermining business confidence and incentives.[3]

Revealing as these recent comments are, the Rowell-Sirois Report itself merits quotation:

> 'Efficiency' in its most narrow sense might be interpreted as economy in collecting the existing taxes. In a broader, and far more important, sense it is skill in collecting a given amount of revenue with the least possible burden on national income. In both senses the Canadian taxation system fails. Duplicate tax machinery, inadequate and divided jurisdiction (involving cumbersome and expensive devices to do indirectly what the constitution prevents from being done directly), and lack of uniformity all contribute to unnecessary expense and reduced returns. Of immensely greater concern, the lack of co-ordination in tax policies, and the almost uniquely high proportion of the Canadian taxation burden on costs rather than on profits, reduce the Canadian national income seriously. The national income is depressed in both a positive way, through restriction of marginal investment, production, and employment, and in a negative way through obstruction of the use of fiscal policy as a stimulant.[4]

The consequences of allowing the situation to continue were, in the Commission's view, very bleak indeed:

> ...increasing friction between governmental units, increasing double taxation, increasing arbitrary, discriminatory and confiscatory tax levies, increasing costs of tax compliance, increasing disparities in taxation burdens and government services between regions, and increasing disparities between burdens on and opportunities open to individuals.[5]

These are sobering words indeed, particularly if one recognizes that this competition over tax revenues was one of the factors that led the Report to warn Canadians of the dangers of protectionist or beggar-thy-neighbour policies that had within them the seeds of balkanizing the Canadian economy.

Without taking a position on the overall recommendations of the Rowell-Sirois Commission, the Council feels confident in reading into this experience the lesson that Canada must not once again allow its tax system to lose itself in the depths of a 'tax jungle' where region is pitted against centre and province against province.

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[3] J.C. Strick, *Canadian Public Finance* (Toronto: Holt, Rinehart and Winston, 1973), 7.

[4] Canada, Royal Commission on Dominion Provincial Relations, Report (Ottawa: King's Printer 1940), I, 214-15.

[5] *Ibid.*, II, 134.

The transition from tax rental to tax sharing

The essence of the tax rental system was that the provinces would receive compensation for allowing the federal government to retain control of the PIT. In the early tax rental arrangements this compensation to provinces was not related directly to the potential PIT revenues that would arise within the jurisdiction. The first move in this direction came with the 1952 arrangements, under which the provinces could opt for 5 per cent of the federal rate for the PIT. This was the transitional step between tax rental and tax sharing, the latter becoming formalized in the 1957 arrangements. The distinctive feature of tax sharing was that the provinces got back an amount equal to what the standardized rates would have generated within their respective jurisdictions. This implied a much greater revenue per capita for the rich provinces than for the poor ones. Hence, it was fully consistent that along with the move toward full tax sharing the federal government inaugurated the first equalization program (see Table 5).

The Tax Collection Agreements

The Tax Collection Agreements, established in 1962, are now in their twenty-first year. The characteristics of these arrangements were dealt with in the first chapter. Towards the end of the first decade of the agreements the provinces began to feel somewhat constrained by their provisions. Responding in part to this dissatisfaction, the federal government accepted the principle of administering and collecting various provincial tax credits. This was a most innovative feature. It gave the provinces considerable freedom to tailor their respective PITs to accommodate the perceived needs of their citizens. Currently, the Tax Collection Agreements again appear to be reeling under strain. In order to obtain a clearer view of these developments, it is useful to consider in some detail the decade of experience with the tax credits. However, it is imporant that we first address a few words to the revenue guarantee.

The revenue guarantee

In the early 1970s, tax reform was the order of the day. The federal government wanted to combine tax reform with an overall reduction in marginal rates, particularly at the top end. However, the possibility existed that the provinces would react to a federal tax cut by generating offsetting increases in their own tax rates. Were they to do so, the net effect of a federal tax cut would essentially be a transfer from federal to provincial coffers with no overall impact on taxpayers—more of their tax would now go to the provinces and less to Ottawa.

Thus, in order to encourage the provinces to go along with the reform-*cum*-tax-decrease, Ottawa proposed, in 1972, the revenue guarantee. In effect, it assured the provinces that, to the extent that they maintained certain parallel features between their own tax structures and the federal tax structure, their income tax receipts under the reformed tax regime would be no less than they would have been had there been no reform. In other words, Ottawa guaranteed provincial revenue from the impact of the 1972 and 1974 reforms. Some details of this reform are reproduced in Table 5.

By 1977, the annual value of the guarantee came close to $1 billion. The provinces were unwilling to accept block funding for the established programs (see the entry for 1977 in Table 5) without some compensation for the termination of the revenue guarantee. As part of the 1977 arrangements they were given the equivalent of two extra personal income tax points. A new guarantee was also part of the arrangements, but it was a very much toned-down version of the original one. It would only apply for one year and then only after provincial revenue losses reached a given threshold level. In the 1982 fiscal arrangements the old revenue guarantee resurfaced. The federal government withdrew the two tax points (or, rather, the cash equivalent of two tax points) that were part of the 1977 arrangements. The provinces were, predictably, furious but there was little they could do. After all, the fiscal arrangements are an act of the federal parliament and therefore, under federal control.

This experience with the revenue guarantee highlights two aspects of the current Tax Collection Agreements. First, action by Ottawa with respect to the PIT automatically affects provincial revenues, unless the latter are protected by some sort of revenue guarantee. Second, even stop-gap measures, such as the revenue guarantee, are in the final analysis also federal programs and thus under federal control. There is no question that Ontario felt short-changed by the events leading up to and including the 1982 arrangements. Likewise, there is probably little question that this was but another of the factors that led Ontario to request a report on the possible benefits and costs of a separate PIT.

TAX CREDITS AND THE PIT

As noted above, issues of tax reform dominated the taxation field in the late 1960s and early 1970s, following in the wake of the Carter Commission on Taxation. Throughout this process of tax reform, the provinces must have felt a bit left out, particularly since it was also 'their' tax that was undergoing reform. To be sure, they were free to mount their own lobbies and it is even likely that their views on the various issues were accorded higher priority by federal officials than the views of private-sector special interest groups. But when all was said and done, the provinces, if they remained signatories to the Tax Collection Agreements, would have to abide by the definitions of taxable income, the exemption levels, etc. that Ottawa saw fit to implement. Fairly early in the negotiation process the Government of Ontario undertook two significant initiatives. The first was a statement by Ontario Treasurer McNaughton in his 1969 budget that Ontario was prepared to establish its own tax system within two years. This move was deemed necessary because the province felt it had virtually no role in determining the structure and method of income taxation appropriate for Ontario and because there was no guarantee that this would change in the upcoming reform process. The second initiative was a request that the federal government provide some flexibility for Ontario to implement tax reform on its own: specifically, Ontario proposed that it be allowed to introduce a system of property tax and sales tax credits.

The province did indeed receive some considerations from Ottawa. Even though Ontario may have been unhappy with certain aspects of the tax reform, one incentive to comply came in the form of a revenue guarantee (discussed above). This guarantee even applied to Quebec, although it was not a signatory to the Tax Collection Agreements. Secondly, the federal government agreed to administer, for a fee, Ontario's tax credit. Some Ontario observers argue that this was part of the trade-off whereby Ontario would agree to the federal redefinition of the tax base. In any event, this initial provincial tax credit, enacted in 1972, was only the first of many and varied credits initiated by the provinces as they utilized this new-found flexibility within the existing Tax Collection Agreements.

Ontario tax credits

The announced rationale for the 1972 Ontario tax credit (initially restricted to property taxes and later extended to sales taxes in order to soften the impact of the Ontario sales tax hike from 5 per cent to 7 per cent) was: (1) to refund sales and property tax paid by families and individuals too poor to pay income tax and who received no benefits from increases in exemptions associated with the federal tax reform; (2) to match income tax burdens more closely to ability to pay; (3) to replace grants and exemptions with credits that more accurately reflected ability to pay; (4) to achieve better integration of major municipal and provincial taxes.

More recently, Ontario has introduced a political contribution tax credit, a selective tax reduction to ensure that persons who pay no federal tax also pay no provincial tax, and, in 1981, a temporary home heating tax credit. The federal government administers all of these tax credits.

Use of tax credits by other provinces

Not surprisingly, Ontario's initiative proved very popular and most other provinces followed suit by introducing their own tax credits. A catalogue, by province, of the various credits, rebates, and surcharges administered by Ottawa as part of the personal income tax appears in Table 6. Note that this table covers only those credits in existence as of spring 1981. Hence, Ontario's temporary home heating tax credit is not included in the table.

Two observations are relevant here. First of all, in spite of the fact that a province is constrained to apply a single rate to basic federal tax, the existence of tax credits provides a province with a considerable degree of flexibility in terms of influencing the progressivity of income taxes. Indeed, once the federal government has accepted the principle of provincial surcharges (in the case of Saskatchewan and B.C.) or negative surcharges (i.e., tax cuts, as is the case for New Brunswick), it is a step more of degree than of substance to allow provinces to adopt their own rate schedules, which would be applied to the federal tax base. A series of surcharges (positive or negative) would also provide this result but would probably be more complex administratively. As was noted in the previous chapter, we shall return to this concept of 'tax on base' as an alternative to the present procedure of 'tax on tax' later in our report.

The second observation that is suggested by Table 6 is that some of these credits are in effect designed to *offset* federally introduced initiatives. This is particularly true of the royalty rebates implemented by the four western provinces. It is instructive to focus on one of these, the Alberta royalty tax rebate. As the documentation in our background study indicates, Alberta takes the view that royalties are a legitimate business expense and that they should, therefore, be subtracted from gross income in calculating taxable income. However, the federal government has disallowed the deduction of crown royalties for purposes of calculating corporate income tax. Thus, for people paying crown royalties, taxable income under federal rules is higher than it would be if these royalties were deductible. The purpose of the royalty tax rebate is to refund *Alberta* income tax on the non-deductible portion of crown royalties. This rationale is quite distinct from that associated with most of the other tax credits. If the principle could be extended, it might mean that provinces would be able to offset, in terms of their own tax, those federal initiatives that alter the definition of income in ways which the province deems to be undesirable.

In general, however, the bulk of the tax credits listed in Table 6 are concerned with establishing norms of equity and progressivity or with alleviating specific instances of hardships. More recently, however, the provinces have shown an increasing interest in utilizing the tax system and other policy levers to promote

TABLE 6
Special features of provincial personal income tax systems, 1981

Province	Tax credits	Tax rebates	Tax deductions	Surcharges
Nfld.	—	—	—	—
P.E.I.	—	—	—	—
N.S.	—	—	—	—
N.B.	Political contributions			Negative surtax of 5.5% of provincial tax otherwise payable
Ont.	Property tax, sales tax, political contributions	—	Selective	—
Man.	Property tax, cost of living, political contributions	Royalties	Selective	—
Sask.	Mortgage interest	Royalties	Selective	Surcharge of 11% on provincial tax in excess of $4,000
Alta.	Royalties, renters, political contributions	Royalties	Selective	—
B.C.	Renters, political contributions, cost of living	Royalties	Selective	Surcharge of 10% on provincial tax in excess of $3,500

SOURCE: Allan J. MacEachen, *Federal-Provincial Fiscal Arrangements in the Eighties* (Ottawa: Department of Finance, 1981), Table IV-1.

provincial economic development. In order to assess the implications of this development for the future of the Tax Collection Agreements, it is necessary to focus on the provisions laid down by the federal government for the acceptability of tax credits.

The criteria for acceptable tax credits

In accommodating Ontario's initial tax credit, federal Finance Minister John Turner outlined the criteria whereby Ottawa would be willing to administer tax credits. The credits must not alter the uniform progressivity of the income tax and, further they (1) must be in respect of other taxes actually paid, (2) must apply to all residents in a province whether they be personal income taxpayers or not, and (3) must be administratively feasible.

More recently, the federal government has issued a new set of guidelines which place much more emphasis on the need to ensure that the harmony of the tax system is maintained and that tax credits do not interfere with the free flow of goods and capital across provinces. Specifically:

> Three guidelines are followed to determine whether or not a [tax credit] measure will be administered under the Tax Collection Agreements. First, the measure must be able to be administered reasonably effectively. Second, the measure must not significantly erode or have the potential to erode the essential harmony and uniformity of the federal and provincial income tax system. Third, the measure must not jeopardize the efficient functioning of the Canadian economic union by the erection of income tax barriers to normal interprovincial investment flows.[6]

As indicated in Table 5, the federal government has refused to administer several recently proposed tax credits because they would have led to the erection of barriers to the free flow of capital across provincial boundaries. This general area is of sufficient importance that it needs to be dealt with in some detail. We begin this discussion by focussing on Quebec's recent initiative.

The Quebec Stock Savings Plan

Since Quebec is not a signatory of the Tax Collection Agreements, it has a degree of freedom in designing personal income taxation measures that the other provinces do not have. In 1979, it exercised this freedom by introducing its Stock Savings Plan. This measure allows an individual who is a resident of Quebec to deduct up to $15,000, in computing his Quebec taxable income, for purchases of shares of Quebec-based corporations.

To qualify, the corporation must have at least five full-time employees, pay at least 50 per cent of its wages to Quebec residents, and not have more than 50 per cent of its assets in the form of corporate shares or similar investments. The shares themselves must be new common shares, with voting rights, purchased on the primary market. The deduction is limited to the lesser of (a) $15,000 less the taxpayer's deductible contributions in registered pension plans and RHOSPs or (b) 20 per cent of earned income minus the taxpayer's deductible contributions to RRSPs and RHOSPs. While it was generally recognized that a large part of the rationale for the program was to offset the very high marginal tax rates faced by Quebec residents, the appeal of the plan in the eyes of the other provinces was that it might provide a way to use the personal income tax for provincial development

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6 Allan J. MacEachen, *Federal-Provincial Fiscal Arrangements in the Eighties* (Ottawa: Department of Finance, 1981), 54. A more formal discussion and analysis of the Canadian economic union occurs in Part VI below.

purposes. Not surprisingly, perhaps, some of the provinces proposed essentially equivalent measures to be administered as a tax credit by Ottawa. And equally unsurprisingly, Ottawa refused.

Provincial development measures

British Columbia was first off the mark (see the 1979 entry in Table 5). Roughly coincidental with the Quebec initiative was B.C.'s attempt to have Ottawa administer (a) a dividend tax credit and (b) a small business venture capital corporation tax credit. The dividend tax credit would have allowed individuals credit from provincial tax payable for 5 per cent of dividends received from public corporations with their head offices and central management in British Columbia. The federal response, from Finance Minister Jean Chretien and later from Finance Minister John Crosbie, was predictable — the proposed measure would erect barriers to the free flow of capital across boundaries, and so it contravened the letter and the spirit of the Tax Collection Agreements. At one point John Crosbie asked British Columbia to extend the measure to include dividends of all corporations, whether domiciled in B.C. or elsewhere. This would have removed the discriminatory feature of the dividend credit.

Overall, the message was clear. Quebec could engage in such policies but other provinces could not as long as they took part in the Tax Collection Agreements. Partly as a result of this message, B.C. served notice that it was contemplating withdrawing entirely from the collection agreements for both personal and corporation taxation.

Saskatchewan proposed to establish a personal income tax rebate for provincial tax payable on capital gains on family farms and small businesses. The federal government refused to administer it on grounds that it constituted a redefinition of the tax base and would exempt income from provincial tax that was included for federal tax. Saskatchewan withdrew its proposal and enacted a separate rebate program *outside* the personal income tax.

Much the same sequence of events occurred with respect to Alberta's proposed Rental Income Tax Credit. It was introduced in the Alberta Legislature in May of 1980. Essentially it was an Alberta 'MURB'. The legislation embodied a tax credit of 5 per cent of the capital cost of a qualifying Alberta building, excluding land, to a maximum of $3,000 per residential unit contained in the building. The amount of the credit was not to exceed Alberta income tax payable, with any excess eligible to be carried forward. The federal government responded by saying that the initiatives would distort the efficient operation of the Canadian economy and would undermine the essential harmony of the personal income tax system. However, in refusing to administer the program, Ottawa did not argue against the philosophy underlying the initiative. Indeed, it *suggested that Alberta could implement such a program outside the PIT system*. And Alberta did exactly that: the program was instituted under the aegis of the Department of Housing and Public Works Act.

The Province of Ontario has not attempted to introduce provincial development tax credits through the PIT. It has, however, accomplished essentially the same thing, outside the PIT, with its Small Business Development Corporations Program, which will be discussed in Chapter 9.

The message that appears to emanate from all this is twofold. First, provincial governments have become increasingly concerned with issues of provincial economic development. Moreover, the development programs they have enacted or proposed tend to be quite discriminatory, in the sense that they are typically designed to provide benefits only to provincial residents and industries based in the province. The second part of the message is that the federal government has not allowed these programs to be incorporated into the PIT system, but has not objected to them when they are implemented outside the PIT or through a provincial expenditure program. This willingness to trade substance for form will receive further analysis and evaluation later in this report, as will the subject of discriminatory provincial initiatives. However, it is appropriate to point out in passing that Ottawa's own slate is not exactly clean on the score of discrimination. Many federal initiatives (such as DREE, the regional aspects of unemployment insurance, and regionally differentiated federal income tax credits) also serve to fragment the internal common market. It is possible to interpret what the provinces are requesting as the right to implement similar measures within their own jurisdictions.

The recent B.C. credit: a new precedent?

In the summer of 1982, the federal government agreed to administer, under the Tax Collection Agreements, the Housing and Employment Development Bond Tax Credit proposed by British Columbia. The program is designed to allow the provincial government to issue bonds to provincial residents and to use the proceeds to lend to enterprises in housing and other sectors. The bonds could be issued at lower than market rates since individuals will be able to claim a flat rate credit of 13.5 per cent of interest received for provincial income tax purposes. This lower interest rate will then be passed through to the borrowers of the funds.

That Ottawa has agreed to administer this credit is somewhat surprising in light of its previous stand on the tax credit proposals of Alberta, Saskatchewan, and B.C itself. There is no question that as a result B.C. has been able to alter the definition of taxable income for provincial PIT purposes. Likewise, the scheme represents an impediment to the free flow of investment funds across provincial boundaries. It may well be that because the scheme was directed primarily toward the housing sector at a time when mortgage rates were very high the federal government found it difficult to refuse to administer the credit. Perhaps the federal government has now decided to be far more flexible in administering provincial tax credits, even if they involve an alteration in the definition of income and even if they represent a barrier to the flow of commerce across jurisdictions. If this is indeed the case, then this tax credit will serve as an important precedent and surely will result in a veritable flood of similar proposals from other provinces seeking to utilize the provincial PIT as an instrument of provincial development policies.

IMPLICATIONS

The inauguration of tax credits in 1972 provided the provinces with a new degree of flexibility within the Tax Collection Agreements. The demand for such measures reflected both provincial concern over proposed federal tax reform and the provinces' desire to target their portion of the PIT to the needs of their own citizens. As the 1970s came to a close, there were new strains developing for the Tax Collection Agreements. Concern over matters relating to income distribution gave way to concern over provincial development policies and the allocation of investment funds within the provinces. Part of this concern probably reflected the weakened economic prospects. Part is likely attributable to major sectoral policies ushered in by the federal government and the corresponding desire on the part of the provinces to either counteract or augment these initiatives.

The initial federal response to provincial PIT initiatives arising from this shift in concern was to refuse to administer them because they violated the spirit of the Tax Collection Agreements. This did not stop the provinces from implementing these programs: it merely meant that they were undertaken as part of the expenditure process rather than the taxation process. The recent B.C. proposal and its acceptance by the federal authorities may imply that Ottawa has reconciled itself to the fact that preservation of some semblance of the Tax Collection Arrangements means that it will have to be more flexible in assessing which credits it will allow and which it will not.

From the Council's standpoint this fascinating series of events leads to several important issues. Is the preservation of tax harmonization an important goal? Is maintenance of an internal common market, free of barriers to mobility of goods and capital, an ideal toward which the nation should be striving? If the answer to these questions is in the affirmative, then the question arises whether the Tax Collection Agreements are the appropriate mechanism for achieving such goals, particularly when they can so easily be sidestepped by actions on the expenditure side of the budget. More interesting still, if these province-building initiatives are going to proliferate, what is there left as an advantage of having a uniform tax system? All these issues will receive our attention in this report. For now, however, our goal is to continue to focus on various aspects of the *status quo* with respect to the PIT in Canada. The next chapter deals with the Quebec taxation system.

3

Quebec's experience with a separate PIT

The purpose of this first part of our report is to assess the nation's current situation with respect to the PIT. This assessment will provide a context in which to evaluate the pros and cons of Ontario's taking the further step of establishing its own PIT. Chapter 1 addressed the current state of personal income taxation in Ontario and Canada. Chapter 2 reviewed the historical experience relative to the PIT. It discussed in some detail (a) those episodes that had a significant impact on the degree to which the PIT became more or less harmonized and more or less centralized and (b) the recent developments associated with the introduction of tax credits. The purpose of the present chapter is to focus on Quebec's experience with its own PIT.

The Quebec experience provides numerous insights relevant to a broad range of issues that are treated later in the report. However, this experience is also relevant to our present purpose, since the separate Quebec PIT is part of the existing personal income tax framework in Canada. The mere existence of a Quebec system implies that a similar move on Ontario's part is not only constitutionally acceptable but also entirely feasible. The question is whether such an Ontario initiative would also be desirable on economic grounds. And before we can begin to grapple with this question it is essential that we review selected aspects of the Quebec experience.

The questions that will be addressed in this chapter include the following:

- —Why did Quebec opt to go it alone on personal taxation in 1954 and does this decision provide any rationale for a similar move by Ontario in 1983?
- —As a result of its having its own PIT, has Quebec's leverage on the overall structure of the PIT been increased?
- —How and toward what ends has Quebec utilized its freedom to develop its own PIT structure?
- —What lessons can we learn from Quebec regarding the degree to which the harmony of the overall PIT system might be affected by a separate Ontario PIT?

The administration and compliance costs of the Quebec PIT and the manner in which the Quebec PIT has provided a cornerstone for an overall system of socio-economic programs are subjects more appropriate to later chapters and will be dealt with here only in passing.

WHY DID QUEBEC ADOPT ITS OWN PIT?

There can be little doubt that Quebec's move in 1954 to establish its own PIT was the outcome of a power struggle between Quebec and Ottawa. However, as our background research makes clear, and as is also very evident from the report of the influential Tremblay Commission,[1] what was at stake was not only the power to tax but also the power to spend for provincial purposes. By implementing its own autonomous PIT, Quebec was in effect challenging Ottawa's implicit claim, based on superior financial resources, that it had the right to determine areas of provincial jurisdiction where the national interest required that more monies be spent. Quebec saw the constitutional authority to levy direct taxes as the foremost symbol of fiscal autonomy at the provincial level. To be kept on a tight fiscal leash by Ottawa was, in the province's view, equivalent to subordination to the federal government across the entire fiscal front. Thus, as the background study suggests, to the extent that a provincial PIT was a symbol, it was initially less a symbol of fiscal autonomy in the field of taxation than a symbol of autonomy in the field of public expenditure.

What evidence there is appears to support such a view. Prior to 1954, Ottawa was successful in transferring certain programs from the provincial to the federal arena—unemployment insurance, family allowances, and old age pensions. In other words, programs that once fell under provincial jurisdiction were now financed, regulated, and administered by the federal government. The experience with federal programs initiated *after* 1954 was quite different. The federal government continued to engage in significant spending programs—hospital insurance, medicare, social assistance, etc. But all of these were *shared-cost programs*, with provincial administration.

Moreover, Quebec obtained the right to opt out of these programs and to receive a PIT tax point-transfer in lieu of federal cash grants. In 1964, these opting out arrangements were extended to all provinces. Thus it does indeed seem to be the case that Quebec used the leverage of its own PIT system to obtain more control over a wide range of expenditure decisions.

Might this be a rationale for a separate Ontario PIT? It might. It is a matter of record that Ontario was strongly opposed to the 1982 Fiscal Arrangements Act, particularly with respect to the federal government's actions on the 'established programs' (hospital insurance, medicare, and post-secondary education) front. When these programs were initiated, they were open-ended, 50 per cent, cost-sharing programs. Because the provinces were spending 50 cent dollars, expenditures on the programs escalated rapidly. Then, in 1977, the federal government block-funded these programs, in effect converting them into unconditional grant programs with the provinces now responsible for any cost overruns. Ontario was rather successful in paring down program costs. However, the federal government now put forth the claim that some of the provinces (particularly Ontario) were underspending on these programs, a claim that it used as part of its justification for the further federal retrenchment in the 1982 Fiscal Arrangements Act. Ontario's view of what it refers to as the 'record of federal retrenchment' is contained in a rather sobering Budget Paper appended to the Ontario 1982 budget.[2]

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[1] For an English translation of this important document, see David Kwavnick, *The Tremblay Report* (Toronto: McClelland and Stewart, 1973).

Thus, it probably is the case that Ontario feels that Ottawa has used the power of the federal purse to coerce the provinces to undertake, in areas under provincial jurisdiction, expenditures geared to federal rather than provincial standards. On the other hand, it is also the case that Ontario has not acted on its option to 'opt out' of the programs. Nor has it, for example, followed Quebec's lead in utilizing the option to tailor family allowance payments to provincial needs. In short, despite some obvious and deep-seated disagreements pertaining to the federal government's role in the sphere of expenditures relating to areas under provincial jurisdiction, the Council does not feel that the rationale for Quebec's 1954 PIT decision fits very well with the concerns of Ontario in 1983. On the other hand, we are not sufficiently knowledgeable or confident to disregard this motive outright.

However, the Council is in full agreement with one of the major conclusions of the background research paper on Quebec's experience: the long-term influence of the 1954 decision on the future evolution of federal-provincial relations should not be understated, for it reasserted fully the principle that each province can adopt *vis-à-vis* personal income taxation whatever policy it deems appropriate as regards both tax rates and the structure of the tax.

QUEBEC'S INFLUENCE ON THE FEDERAL PIT

One role for a separate PIT would be to exert influence on the structure of the federal PIT. How much influence has Quebec had on the evolution of the federal PIT and, more generally, on federal-provincial financial arrangements? Would a separate Ontario PIT give this province similar leverage?

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[2] Frank S. Miller, 'Fiscal Federalism in Canada: The Record to Date, the Challenge Ahead', Budget Paper, *Ontario Budget, 1982* (Toronto: Ministry of Treasury and Economics, 1982).

The answer to the first question appears rather obvious. To draw once again from the background study, the 1954 initiative can be said to constitute a watershed in the country's constitutional evolution and certainly in the history of federal-provincial financial arrangements. Much of the evidence for this has already been provided—the movement toward shared-cost programs and opting-out provisions in place of federally financed and administered social programs; the movement away from the Tax Rental Agreements toward tax sharing; and, finally, toward the present Tax Collection Agreements, although one has to admit in regard to this last process that Ontario, by its actions in 1947 (with respect to corporate taxes) and afterward, also exerted considerable leverage on Ottawa. In addition, Quebec probably played a major role in altering the federal tax reform proposals in the late 1960s and early 1970s: after considerable negotiation, Quebec agreed to parallel the federal tax reform proposals, and no doubt part of the negotiation process involved efforts to modify the original federal proposals to satisfy some of Quebec's desires. And so on.

Could a separate Ontario PIT accomplish similar modifications in the structure of the federal personal income tax? On the positive side of the ledger is the fact that Ontario would presumably have a substantial group of highly informed bureaucrats capable of confronting their federal counterparts on the full range of personal income taxation issues. Without a countervailing bureaucracy fully aware of the technical, administrative, and policy complexities of the PIT, Ontario would be at a severe disadvantage in any round of negotiations.

On the other hand, the Quebec situation does strike the Council as being in many ways unique. As long as it is the only province outside the system and as long as its particular needs are justified at least partly by historical and cultural arguments, its bargaining power with Ottawa is likely to be magnified. This is a very different situation from one in which Ontario and possibly the two westernmost provinces were also operating their own independent PITs. Given such a situation, more than 75 per cent of the provincial PIT revenues would arise outside the agreements and the rationale for uniformity and harmonization would become correspondingly less compelling, since the federal government could only guarantee such harmonization for a very small portion of overall provincial tax revenues.

Once again, therefore, the Council finds itself unable to take a strong position. We simply do not know how effective a separate Ontario PIT would be in terms of its influence on the federal government's own PIT tax structure. However, it is worth emphasizing the obvious but important point that in these circumstances federal changes would not automatically affect the Ontario PIT, as they currently do. This issue will arise in a different form later in the report.

A more important issue, in some respects, is the following. Would the existence of a separate Ontario PIT inevitably mean that over time the Ontario and federal tax systems would diverge with respect to such things as rate structures, definitions of income, and allowable exemptions? These issues loom large when it comes to estimating the likely administrative and compliance costs of an Ontario PIT. Even though we recognize fully that the Quebec experience may not provide an appropriate precedent, it is instructive to focus on the manner in which the Quebec PIT has diverged over the years from the federal PIT. Table 7, reproduced from the Council's background study, provides a summary of these differences.

In the background document released in connection with the 1982 Ontario budget, the Treasurer appears to argue that the differences that would arise between the Ontario and federal tax structures would be minimal (e.g., 'it is unlikely that the definition of employment income for Provincial income tax purposes would deviate from the federal definition'). This, of course, is entirely possible. However, despite well-intended assertions to the contrary, the Council is persuaded by the evidence in its background study that the variations Ontario adopted under a separate personal income taxation system would likely be similar in pattern to those adopted by Quebec, even if they were adopted for entirely different reasons. It is not difficult to foresee circumstances in which Ontario would claim to have different social or economic objectives than those motivating federal tax changes, with the result that over a decade or so Ontario, like Quebec, would produce a personal income tax system that differed significantly from that of the federal government. This is not to say that such divergences would be undesirable — after all, presumably the principal rationale for pursuing an independent path for personal taxation would be to tailor the tax structures to the perceived needs of the citizens of Ontario. Rather, the point at issue here is whether or not the sorts of divergences in Table 7 are likely to be a useful guide in terms of indicating just how Ontario might use its PIT flexibility. We think that Table 7 is valuable in this connection.

Finally, a word about the natural tendency that exists towards harmonization. One might expect that the technical or non-substantive differences in tax regimes would be minimized or eliminated by pressure from taxpayers, although there would be some unavoidable lags in the process. The evidence from the Quebec experience indicates that, for this province at least, there is not all that much to the notion of harmonization. What does appear to be true is that the basic income tax concepts, particularly when embodied in case law, do in fact remain unaltered for long periods of time. But this circumstance may very well be more a feature of lawmaking in federal countries than a product of any notion of harmonization.

TABLE 7

Ways in which Quebec personal income tax has departed from federal personal income tax

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Revenue

Non-indexing of tax rate table.

Equity or Redistribution

Higher basic exemptions.
Higher top rate.
Different relief for children.
Real estate tax refunds.
Different rate progression.
Higher benefit for company cars.a
Lower deductions for personal cars used to earn income.a
No education deduction.
No housing loan exemption.a
Benefit from employee loan not computed on same basis.

Savings and Investments

Current service contribution to RPP $5,500 rather than $3,500.
Deduction up to $15,000 in stock savings plan.
Investment credit of 25 per cent on SODEQ shares.
Capital gains not eligible for $1,000 deduction.
All interest expense deductible re $1,000 deduction.
Capital loss deduction of $1,000 not $2,000.

Special Incentives

$3 for $1 RHOSP contribution for 1982 only.
Quebec does not exempt employees' stock option benefits from tax as the federal measures do for private Canadian-controlled corporations.
Contribution to RRSP limited to $3,500 if employee member of DPSP (federal now has the same limit when contributions to DPSP made in the year).
RHOSP cannot be used to buy a house from the spouse in Quebec.
For 1983 and following years contribution may be made to RHOSP but no deduction.

Miscellaneous

Unpaid balance is always subject to interest charge; interest on refund starts only 60 days after filing or April 30th, whichever is later.
Child care expense limits $2,000/child and $6,000/family instead of $1,000 and $4,000 federally.
Limitation in deduction of legal fees to obtain maintenance payments (Que. 133.3); may be allowed by federal authorities (IT-99R).
Differences in interpretation of the same legislation.

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a Before budget of November 12, 1981.

SOURCE: Chapter 5, background document.

ABBREVIATIONS: SODEQ—Quebec Business Development Corporations, RHOSP—Registered Home Ownership Savings Plan, RRSP—Registered Retirement Savings Plan, DPSP—Deferred Profit Sharing Plan, (IT-99R)—Interpretation Bulletin 99 Revised.

Essentially, the evidence, such as it is, appears to suggest that the goal of harmonization easily gives way to higher order goals having to do with issues of substance and also of form. The experience from Quebec suggests that the question of harmonization has been raised only when Quebec wishes to exert leverage on the federal PIT structure. In other words, Quebec has viewed tax harmonization primarily as a federal concern rather than as a priority in terms of its own tax policies. Table 7 provides considerable evidence in support of this point. There is, of course, always the possibility that Ontario would be a different case entirely and that this province would give much greater priority to the goal of harmonization *per se*. No doubt this would be the case as long as Ontario viewed any federal modification as serving a valuable provincial goal as well. If the province found itself unable to sustain this view, it seems to us that the conclusion *re* harmonization for Quebec would carry over for Ontario. This outcome would follow all the more rapidly once there did exist some significant divergences between the two tax systems, since any further changes would only add incrementally to citizens' compliance costs.

The issue of divergences between the tax structures and the role that should be assigned to the process of harmonization is critically important in assessing both the administrative and compliance costs associated with a separate PIT. As a final chapter in this part of the report dealing with the *status quo*, we turn briefly to those divergences that have developed between the Ontario and federal *corporate* tax structures. This may provide further insight relative to the structure of an Ontario PIT.

4

Corporate income taxation: harmonization or divergence

For a quarter of a century now, Ontario has had a separate corporate income tax. Although there is no legal requirement that the corporate tax structure (definitions for incomes, expenses, exemptions, etc.) parallel the federal scheme, many observers have noted that the differences are not major. Moreover, all provinces have adhered to a common formula for allocating corporate profits across provinces.[1] This means that no income escapes taxation, nor is any income subject to double taxation, in marked contrast with the situation in, say, the United States, where there does not exist a generally accepted formula for allocating profits across states. As a result, the Canadian corporate tax system is often held up as a model tax system when it comes to matters of interprovincial uniformity and harmony. Moreover, the harmony derives from agreement, not from legislation.

Nonetheless, as a result of the November 1981 federal budget, Ontario's corporate income taxation system will differ in significant ways from the federal system. Rather than detail these recent divergences, it is preferable to provide the full rationale for the province's behaviour. From the 1982 Ontario budget:

> It is vitally important, Mr. Speaker, that our corporate income tax policy be appropriate to our economic requirements.
>
> Since last November, I have repeatedly asked Ottawa to reconsider some of its proposed changes to the corporate income tax. I am disturbed about the impact of the capital cost allowance changes on investment in the Ontario manufacturing sector in general and the steel and auto industries in particular. Moreover, the proposed change in the definition of resource income will have a further damaging effect on our steel industry which, through the direct employment of 50,000 people and indirectly many more, is one of the great strengths

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[1] A province is allocated a share of corporate profits in accordance with the following formula: $\frac{1}{2}(Pi/Pc + Si/Sc)$, where Pi/Pc = the province's share of the corporation's Canadian payroll, and Si/Sc = the province's share of the corporation's sales. For more information on this allocation formula and its history see Ernest H. Smith, 'Allocating to Provinces the Taxable Income of Corporations: How the Federal-Provincial Allocation Rules Evolved', *Canadian Tax Journal*, XXIV, 5, September-October 1976, 543-71.

> of the Canadian economy. I am also concerned about the inadequacy of proposed reserve provisions for the disposition of property.
>
> I am encouraged by the fact that no federal legislation has been tabled to date. It is not too late for the federal government to introduce measures that will encourage, not discourage, capital investment and will assist, not penalize, Ontario's industry.
>
> Meanwhile, I am proposing that certain federal proposals not be paralleled in Ontario's corporate income tax system:
>
> —The tax depreciation in the year of acquisition of capital assets will not be reduced.
> —No change will be made to the definition of resource income for the steel industry.
> —No change will be made to existing reserve provisions.
>
> With these actions, the Province will forgo an estimated $135 million in revenue this fiscal year.
>
> I regret that these steps will reduce the harmony of our federal and provincial tax structures. Nevertheless, I will not propose that this House parallel, in the Corporations Tax Act, measures that could damage employment and investment prospects in Ontario.

These measures place in stark contrast Ontario's freedom on the corporate income tax side and its lack of such freedom on the personal income tax side, where the province has to accept in its own tax structure changes that it may deem equally inappropriate for the 'employment and investment prospects of Ontario'. In the context of this chapter, however, a more important point is that these recent initiatives account for only some of the differences between the Ontario and the federal corporate tax systems.

Table 8 summarizes the major differences between the two corporate tax regimes. (Appendix 5C of the background study describes these differences in more detail.) Even though the Canadian corporate tax system may, by international comparison, qualify as highly coordinated, there do indeed exist a considerable number of structural differences that must be taken into account in assessing the cost of taxpayer compliance. More importantly, these divergences in the corporate system lend some further evidence to our earlier suggestions that, over time, we would expect a separate Ontario PIT to incorporate a variety of structural elements that would be different from those of the federal PIT.

Thus Ontario's experience with the corporate tax points in conflicting directions with respect to the issue of tax harmony. Quite apart from the two most recent provincial initiatives, it does appear that the two tax systems are diverging considerably. Yet, in terms of preserving overall interprovincial harmony, the Ontario system has adhered to the allocation formula for allocating corporate profits across provinces. It should be added, however, that it took a great deal of time and effort to hammer out an allocation formula acceptable to all parties. In other words, as is the case for the PIT, the degree of harmonization and coordination that does exist is a product of considerable negotiation and compromise.

TABLE 8
Summary of differences between Ontario and federal corporate tax systems[a]

1. Liability for income tax
   - Residency status
   - Non-resident entertainment corporations
2. Calculation of net income
   - Capital property
   - 115 per cent depreciable cost incentive
   - Beef cattle stabilization program
   - Interest on loans to non-resident persons
   - Treatment of management fees, rents, royalties, etc.
   - Capital cost allowances
   - Reserves — capital gains
   - Income revenues
   - Foreign taxes
   - Taxable crown corporations
   - Deductible corporate taxes
   - Payments received under the Employment Support Act
   - Foreign tax carry-over on amalgamations
   - Partnerships and their members
3. Computation of taxable income
   - Political contributions
4. Calculations of taxable income payable
   - Small business deduction
   - Foreign tax credit
   - Incentive tax credit for investment
   - Manufacturing and processing profits credit
   - Political donations credit
   - Employment tax credit
5. Resource Corporations
   - Resource allowance
   - Depletion allowance
   - Foreign resource property
   - Development expenses

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[a] For more detail on these provisions, consult Appendix 5C in the background study.

Part I: Council summary observations

—The history of the PIT system reflects all the tensions that beset federal-provincial financial relations generally.

—The personal tax field was occupied originally by the municipalities, then by the provinces, and only in 1917 by the federal government. Under the pressure of the Depression, the Canadian tax system degenerated into a 'tax jungle'. The PIT was centralized in federal hands during the Second World War. In the post-war period, the PIT system has been moving slowly in the direction of decentralization once again. Nonetheless, there is still a high degree of harmony and coordination associated with the present system, so much so that the Canadian system is often cited as a model for other federations.

—Under the Tax Collection Agreements, the federal government bears all the costs of collecting and administering provincial personal income taxes. The provinces are limited to applying a single rate of tax to 'basic federal tax'. Moreover, they have to parallel in their tax systems any and all federal tax structure changes. Both currently and historically, the provinces have had little influence on the decisions of the federal tax authorities with respect to the determination of the federal personal income tax base or rate structure. To be sure, there have been some notable exceptions to this rule, for example, the federal-provincial tax-structure committee of the 1960s.

—In 1972, the Province of Ontario was able to persuade the federal tax authorities to administer a personal income tax credit on behalf of the province. Aside from the province's freedom to alter its tax rate on 'basic federal tax', the PIT credit structure provides, for all intents and purposes, the only provincial avenue for policy implementation through the PIT system.

—There has been a proliferation of tax credits in the last ten years. In general, for these credits to be accepted by Ottawa, they must (1) be administratively feasible; (2) respect the harmony and uniformity of the overall system; and (3) not jeopardize the functioning of the Canadian economic union.

—In the past few years, tax credits proposed by several governments have been rejected by the federal authorities because they represented barriers to the free flow of goods and services across provincial boundaries. However, these provinces were allowed to mount these programs outside the tax system. Hence, while the tax collection agreements may be enforcing an internal common market within the tax system, they are having little or no impact in securing an overall internal common market.

—The recent British Columbia credit may be a signal that Ottawa is allowing more flexibility in the system. However, this credit appears to run counter to the federal rule preventing tax measures which discriminate jurisdictionally.

—Since 1954, Quebec has had its own separate PIT. Hence not only is there no constitutional roadblock to such a move on Ontario's part, but such a PIT system is feasible as well. It is interesting to note that Ontario has never set in place a PIT system complete with a collection agency, although on at least one occasion it served notice that it intended to do so.

—Quebec has appeared to have had considerable influence on the evolution of federal-provincial financial matters since it adopted its own PIT.

—Over the years, there has developed a rather large set of divergences between the concepts and definitions embodied in the Quebec PIT and those in the federal legislation. This might be the same for an Ontario PIT.

—On the corporate side, Ontario has long had its own tax system. Over time, there has also developed a sizeable set of divergences between Ontario and Ottawa with respect to the underlying concepts and definitions. However, Ontario has continued with its commitment to the formula for allocating corporate profits across provinces, thereby maintaining the highly coordinated nature of the corporate tax system.

—In the November 1981 federal budget, the Minister of Finance proposed several major tax changes for both the personal and corporate tax systems. In his Ontario budget, the Treasurer did not parallel those features of the federal tax on the corporate side that were not deemed to be in the interest of Ontario. Under the Tax Collection Agreements, there is no corresponding flexibility on the personal income tax side.

PART II
Growth and Efficiency

5

A framework for evaluating the allocative implications of an Ontario PIT

INTRODUCTION

Beginning with this part of the report, attention is directed to the potential economic costs and benefits that would attend a separate Ontario PIT. When evaluating the implications of any policy change, economists typically focus on a three-fold classification of effects — allocative efficiency, economic stabilization, and income distribution. Our focus in the chapters in this part is on the efficiency goal, leaving stabilization and distribution to be covered in Parts III and IV respectively.

The terms 'growth' and 'efficiency' will be used interchangeably and will cover both aspects of what is generally understood by allocative efficiency: (1) 'static efficiency', that is, the efficiency of resource allocation at a given point in time, and (2) 'dynamic efficiency', that is, the efficiency of resource allocation over time. Improving the former will bring about a once-and-for-all increase in the *level* of output of goods and services, whereas increasing the latter will generate an increase in the *rate of growth* of output over time. In principle, the analysis in this part of the report is conducted under the assumption that the economy is already at full employment. In practice, however, many of the investment programs detailed later can also be viewed in the context of measures designed to bring the level of ecomomic activity closer to its full-employment potential.

The central analytic task relating to the interaction between economic growth and an Ontario PIT is really a twofold one. First, would it be possible, by deft manipulation of an Ontario PIT, to increase real per capita output in Ontario on a long-term basis? In turn, this question revolves around the ability of an Ontario PIT to increase one or more of the acknowledged determinants of economic growth:

— increasing the fraction of those of working age who are in the labour force and/or their hours of work;

— increasing the proportion of skilled labour in the labour force;

— increasing the overall investment in Ontario and Ontario-located enterprises and reallocating existing investment levels into high productivity areas.

Chapter 6 focusses on the impact of a separate PIT on labour supply (the first two of the above determinants of growth), while the remaining chapters in this part deal in one way or another with the last determinant, namely increasing the capital-labour ratio and therefore labour productivity.

As noted above, the question of whether a separate Ontario PIT can increase long term growth is only the first part of the basic issue to be addressed. If the answer to this first question is in the affirmative, then the second question remains to be asked: would an Ontario PIT be the most effective instrument for delivering these increases in long-term growth? To put the question somewhat differently, given that growth can be increased, is an Ontario PIT the best way of going about the process? This two-tier approach to the potential benefits of an Ontario PIT will be applied throughout this and later sections of the report.

ESTIMATED EFFECTS ON POTENTIAL GNP OF ALTERNATIVE POLICY CHANGES

In order to motivate the analysis in the following chapters, it is useful to provide some estimates of the amount by which changes in various economic variables can influence long-term growth. Utilizing the University of Toronto's FOCUS model, a full employment GNP path was generated for the period 1985-95. This so-called 'base case' incorporated an annual real growth rate of 3.56 per cent. Next, four separate simulations were run, embodying the following experiments:

1. a 10 per cent increase in the participation rate for women aged 25-54;
2. a 10 per cent increase in the savings rate;
3. a 10 per cent increase in investment expenditures;
4. a 10 per cent reduction in the user cost of capital.

Note that these simulations have nothing *directly* to do with the impact of an Ontario PIT. It is, of course, possible that alterations in the parameters of a PIT could lead, for example, to an increase in savings or in investment. But these questions are addressed in the following chapters. The purpose of the simulation is to ascertain whether or not changes in labour force participation, investment, etc., *regardless of how they are generated*, are likely to have an impact on ecomomic growth.

The results of the simulations are given in Table 9. While they relate to the Canadian, rather than the Ontario, economy, they are indications of what would likely be the case for the province. A 10 per cent increase in investment leads to an increase in the annual rate of growth of just over 5 per cent. Looked at in terms of constant dollar GNP, the permanent increase in investment leads to a level of GNP after a decade that is nearly $4 billion larger than that generated by the base case.

TABLE 9
Simulation results of hypothetical growth-stimulating policies on potential GNP

	Potential GNP (1971 $ millions)			Growth rates (%)		
	1985	1994-95 Average	Difference from base case	1985-95	Increase over base rate	% of base rate
Base case	153,470	214,017	—	3.56	—	—
Simulations						
1. 10 per cent increase in L.F. participation	153,470	217,358	3,341	3.73	0.17	4.8
2. 10 per cent increase in saving rate	153,470	215,553	1,536	3.64	0.08	2.2
3. 10 per cent increase in investment	153,470	217,735	3,718	3.75	0.19	5.3
4. 10 per cent reduction in user cost of capital	153,470	216,817	2,800	3.70	0.14	3.8

SOURCE: Background study, Chapter 6.

The background study suggests that these are small numbers. Yet it is equally possible to argue that they are large numbers. This is particularly the case when one recognizes the exact nature of the simulation. In the 'base case', the economy is assumed to operate at full employment each and every year. Thus, the impact of the simulation is restricted to influencing this full employment growth path. Moreover, some of the experiments are not as straightforward as might be expected. Continuing with the investment simulation, for example, the 'shock' is a 10 per cent increase in the *exogenous* component of investment each and every year. However, because of the various feedbacks in the model, total investment (i.e., the 10 per cent exogenous increase plus the model-generated portion) increases by only 5 per cent a year on average. This occurs because of the general equilibrium effect of an exogenous boost in investment on other variables in the model. For example, interest rates will rise and in turn exert downward pressure on other investment expenditures. Even so, the overall growth rate increases by 5.3 per cent (i.e., 5.3 per cent of the growth rate) over the decade.

It should also be noted that Table 9 focusses only on dynamic efficiency, as defined earlier. It is also possible to alter the *mix* of investment at any point in time so as to lead to an increase in labour productivity, and hence an increase in potential GNP. For example, a switch in investment from the housing sector to the high technological sectors, assuming full employment, would presumably generate an increase in real GNP. Finally, it must be emphasized that these simulations are independent of one another. Combining an increase in labour force participation with an increase in investment would presumably lead to an increase in potential GNP that is much larger than the impact of either of the separate simulations. In this sense, the Table 9 figures likely underestimate the potential for increasing overall efficiency and, hence, potential GNP. The purpose of these comments is simply to argue that these potential gains are significant enough to warrant delving further into the question of whether an Ontario PIT would be able to deliver such efficiency gains.

Thus far, attention has been directed only to the absolute growth rates and levels in Table 9 and then only to the detailed results for an increase in investment. More relevant, perhaps (and probably more reliable), are the *relative* impacts of these four experiments. For example, a 10 per cent increase in overall savings leads to less than one-half the impact of a 10 per cent increase in investment. This result may appear somewhat surprising, since aggregate savings must equal aggregate investment. However, as will be spelled in some detail in Chapter 7, there are good theoretical reasons for believing that this result should obtain. Essentially, in a small open economy under conditions of rather perfect capital mobility, an increase in savings will have more impact on how aggregate investment is financed (e.g., from domestic or foreign sources) than on determining the level of total investment.

The effect of a reduction in the cost of capital represents an intermediate case in terms of the numbers in Table 9. An excellent example of how the PIT might reduce the cost of capital is the recent federal decision to index, for personal income tax purposes, the inflation portion of any capital gains on equities. This should have the effect of increasing the demand for shares, raising their price and, therefore, lowering the cost of capital to firms. Even here, however, the implications of a small open ecomomy are important in the sense that the resulting increase in investment may occur outside of Ontario. This is, of course, why provinces, when using taxpayers' money to provide investment incentives, have a tendency to link these incentives to enterprises or investments in their own provinces. Such an approach may benefit a province, provided that there is no retaliation either from the federal government or from other provinces. With full retaliation, the process can quickly degenerate into a negative-sum economic game that at best leaves overall investment unaffected and simply lines the pockets of entrepreneurs, domestic and foreign. The subject of province-building via investment incentives will only be touched upon in this part, but a fuller analysis will appear in Chapter 14.

Finally, as was noted above, the analysis assumes that the ecomomy is at full employment and addresses the issue of whether both the level and rate of growth of full employment can be enhanced. In practice, however, some of the measures described below could also be important in bringing the Ontario economy up from its present low level of activity to its full employment level. Thus, while general discussion of stabilization policy is reserved for Part III of the report, substantial stabilization implications arise from part of the analysis that follows (e.g., with respect to the treatment of new ventures and small businesses).

AN OUTLINE OF THE CHAPTERS

This part is at once the longest and the most complicated (and perhaps the most important) section of our report. Hence, it is useful to provide a brief overview of where the analysis is going. Chapter 6 deals with the manner in which an Ontario PIT might affect both the supply of labour in Ontario and the quality (human capital) of the labour force. Chapter 7 focusses on the interaction between personal income taxation and overall savings. An important part of this analysis is a discussion of the relationship between saving and investment in a small open economy. How the PIT might influence investment is the subject of Chapter 8. Basically, the analysis is restricted to large corporations with ready access to international capital markets. Chapter 9 then addresses the important question of whether a separate PIT could influence the level of investment in small businesses and venture capital enterprises. The part concludes on a rather practical note: Chapter 10 deals with the new federal proposals for modifying the overall PIT to correct for the inflation distortion and with how this modification is likely to affect investment and the cost of capital. This is an important case study, since one of the options open to Ontario were it to embark on its own PIT would be to correct the system for these and other such distortions and, hopefully, to convince the federal level to follow suit. In this instance, it is the federal level that has taken the initiative, but had Ottawa not acted this would have been one area in which Ontario might have led the way.

As was noted earlier in this chapter, the approach in most of these chapters will be, first, to address the issue of whether an Ontario PIT might be able to increase growth or efficiency and, second, to find out if there are alternative instruments in the policy arsenal that could accomplish these ends just as effectively.

6
The PIT and labour supply

INTRODUCTION

Labour inputs account for roughly two-thirds of aggregate production costs. Thus, any policy that affects labour supply will also have a major impact on potential GNP. The purpose of this chapter is to assess the degree to which a separate Ontario PIT could influence the supply of labour in the province. In the broadest sense, the labour supply to an open economy encompasses all aspects of the quantity, quality, and allocation (both occupational and geographical) of labour inputs. And in the analysis that follows we shall focus on all three aspects. The first section of the chapter deals with the quantity of labour supplied, by which we mean both the proportion of working age persons in the labour force (commonly referred to as the participation rate) and the hours worked. The second section discusses the interaction between labour quality (education and training) and the tax system. In the final section, attention is directed toward the geographical allocation of labour, i.e., the migration decision.

THE PIT AND LABOUR UTILIZATION

While economists have long attempted to establish empirical relationships between labour supply and 'effective' wages (where 'effective' can be interpreted to take account of the tax system), the conclusion that arises from our background research is that 'the evidence respecting labour supply is far from conclusive'. What does appear to be the case is that, in general, the supply of work effort by men seems to be very insensitive to changes in tax rates. Overall, the most likely effect of increasing taxes, for example, would be a small increase in their hours of work.

However, for married women the evidence points to a much larger tax sensitivity. Empirical evidence suggests that in response to a 10 per cent decrease in income the supply of hours to the labour market by married women would decrease by 5 per cent. Moreover, it appears that the costs of entry into the labour market are a significant deterrent to labour force participation by married women. Included in these 'costs of entry' are such things as the tax treatment of child care expenses and the temporary 'notch' problem associated with the fact that a working wife is, in effect, taxed at the husband's marginal rate until the spousal exemption is exhausted. A separate PIT would allow the province more flexibility in addressing these issues, e.g., more generous child care allowances could be introduced, or the tax structure could provide for income splitting. Overall, however, the evidence is not very compelling that labour supply considerations would justify a separate PIT. Consideration could be given to the costs of entry either outside the PIT system (e.g., through expenditure programs for day care) or under the existing system (probably via an employment expense tax credit). If it is only a question of the *marginal* tax rate, the province currently has the ability to alter marginal rates, albeit only in an across-the-board fashion.

LABOUR QUALITY AND THE PIT

The tax structure can have very important effects not only on the returns to investment in human capital but also on the costs of investing in education. For example, the structure of marginal rates can play a role in the decision to invest in one's human capital. So can the manner in which the tax system treats perks or fringe benefits, since they typically accompany jobs that require considerable education or training. The manner in which inheritances are taxed will likely influence the degree to which parents will pass on their wealth in the form of investment in the education of their children. Similar factors, such as the degree to which educational expenses and tuition fees can be carried forward for tax purposes, can influence the opportunity cost of undergoing training.

Thus, there is some scope for a province to influence the quality of its labour force by means of restructuring its PIT. However, it seems to us that the decision to invest in additional education or training is influenced more by features that fall outside the tax system — the degree of provincial and federal support for education and training centres, which influence the level of tuition fees; the extent and terms of financial assistance under such programs as OSAP (the Ontario Student Assistance Plan) and OGS (Ontario Government Scholarships for graduate education); on-the-job training programs, which can be encouraged by direct expenditure programs or by tax credits on the corporate side. Overall, then, it does not appear to us that the tax system discriminates against training and education. This is not to say that selective modifications would not lead to greater investment in human capital. But it is important to recognize that a good portion of the returns to human capital investment accrue in the form of consumption benefits. This being the case, one could argue that on equity grounds there might even be a case for a taxable benefit associated with the major public underwriting of tuition costs. We point this out, not in the form of a recommendation, but rather as a further piece of information to the effect that it is not obvious to us that the current tax system is prejudicial to human capital investment and, further, that if Ontario were to embark on its own PIT, it is not clear which way it would or should tilt the tax structure for education and training purposes.

TAXATION AND MOBILITY

For 1981, the estimated net outmigration from Ontario to other provinces equals some 21,000 persons; inflows from other provinces are estimated at 69,000 and the recorded outflow runs at 90,000 persons. This, of course, is a very new situation for Ontario. Traditionally, the province has been a net recipient of migrants. The changing economic structure of the federation, particularly the westward drift of activity associated with the energy price increases, has served to alter substantially the allocation of labour across provinces. Much of the current research in internal migration focusses on what is called 'fiscal-induced' migration. The thrust of this new literature is that prospective migrants take into account 'comprehensive income' when contemplating a move. Comprehensive income includes not only wage and salary levels but, as well, public sector benefits, whether in the form of reduced taxes for a given level of public services or enhanced services for a given tax burden. This issue looms important in the face of the fiscal resources of some provinces (particularly Alberta) where, because of the presence of massive resource rents, labour can be induced to migrate in response to these fiscal benefits. For this reason, various analysts have called for modifications of the existing equalization framework in order to ensure that the migration decision is determined by factors relating to economic efficiency rather than by the existence of fiscal (and tax) benefits. Failure to do so may result in some migrants taking up lower-paying jobs in Alberta (thereby decreasing national output), because the overall compensation package, including net fiscal benefits, is larger than the comprehensive income in their present location.

This is all very interesting and, perhaps, very important. The issue at hand, however, is whether or not it is in Ontario's interest to influence migration flows and, if so, whether or not a separate PIT would provide an effective vehicle for accomplishing this. From the outset, one fact is obvious: Ontario is likely to attract more labour if it can get its economy moving again. An independent PIT may have a role in encouraging economic activity, but this is an issue that will be dealt with in Part III of this report. For present purposes, interest centres only on the specific role that an Ontario PIT would have on the migration decision.

The background study surveys some of the voluminous empirical literature that exists on the determinants of migration both in Canada and elsewhere. Unfortunately, very few of these studies actually focus on the impact of income tax parameters (such as the marginal tax rate) on migration. The best guess as to the likely impact of taxes on migration is that a tax change that produced, on average, a 1 per cent decrease in effective earnings in Ontario would, other things equal, generate an increase in outmigration flows of some 900 persons. Given that current outflows are about 90,000, this implies an income elasticity (and, by assumption, a tax-change-generated income elasticity) in the neighbourhood of unity. But this information is not of much relevance in the sense that, in addressing the issue of whether or not Ontario should adopt a separate PIT, we are not talking about a net reduction of taxes. The underlying assumption is that any tax changes arising from a separate PIT would be offset by compensating changes elsewhere in the system of taxes.

What the analysis does suggest, however, is that if Ontario had its own PIT and were willing to alter the marginal rate structure from what it is at present, this action could have an impact on the migration patterns of various income classes.

There is some considerable evidence, more anecdotal that empirically verified, that high marginal rates encourage outmigration. This seems to have been the case with respect to upper-income taxpayers in Quebec. Indeed, the Quebec Stock Savings Plan was introduced in part to reduce the high marginal tax rates faced by upper-home Quebec residents.

Another area where a separate PIT might have a considerable impact on migration relates to the manner in which it would treat executive compensation. In the literature on industrial location, one of the frequently mentioned drawing cards for an area is the tax treatment of executives. Among the provinces, Ontario has the highest proportion of 'fringe benefits' to wages (over 30 per cent of total compensation). Executive compensation in the form of deferred earnings on stock options is often treated differently from other income for tax purposes, and the whole area of 'remuneration planning' can provide appreciable tax savings. With its own PIT, Ontario could clearly tailor its tax structure to these considerations. As a matter of interest, part of the furor over the November 1981 federal budget had to do with the manner in which it proposed to alter the treatment of some of these fringe benefits.

More generally, Ontario could consider modifying provisions relating to employee expenses (e.g., travel costs, provisions for the purchase of tools and equipment) which might have an influence on the locational preferences of workers. In noting these potential measures that Ontario might consider in order to influence the migration decision of persons and even corporations, the Council is not in any way advocating that they be implemented. Rather, they are raised as examples of the way in which Ontario might influence locational preferences if it had control over the structure of its personal income tax system.

IMPLICATIONS

The general conclusion of this chapter is that while personal income taxation does matter in the labour supply process, the limited information available suggests that the overall effects of PIT changes are uncertain but probably fairly small. This conclusion may not apply to certain specific sectors, such as the impact on the labour supply of married women or the attractiveness of the province to corporate executives, where PIT targetting might have a significant influence.

7
The PIT and personal savings

INTRODUCTION

The first part of this chapter focusses on whether or not an increase in personal savings is likely to contribute to an increase in long-term growth. The answer is that it depends on the degree of capital market perfection. Nonetheless, it still may be in Ontario's interest to increase its level or rate of savings. The question then becomes one of whether or not a PIT is an effective way of increasing savings. Despite much empirical work on this issue down through the years, the answer is not at all obvious. The final section of this chapter focusses on the distortions in the treatment of various types of savings. At this level, it is possible to provide some more definitive answers—a PIT may not be able to influence the overall level of savings, but it can and does have a major influence in the channels through which citizens save.

SAVINGS AND GROWTH: ONTARIO AS A SMALL, OPEN ECOMOMY

The standard conclusion that an increase in savings will increase investment assumes either that the economy is closed or that international capital markets are imperfect. This situation is depicted in Figure 1, where the intersection of the savings schedule (SS) and the investment schedule (II) determines the rate of interest (r_0) and the level of the savings and investment (S_0 and I_0). Savings are assumed to rise as the rate of interest increases so that the SS curve has a positive slope. And vice versa for the investment schedule. Now let there be an increase in savings from SS to S^1S^1—i.e., savings are larger for each and every rate of interest. The new equilibrium is characterized by a lower interest rate (r_1) and an increase in both savings and investments (S_1 and I_1), the latter occurring because, as interest rates fall, more investment projects become economically viable.

Matters are very different in an open economy. This is shown in Figure 2. Once again, let II be the investment schedule and SS be the *domestic* savings schedule. Under the assumption of perfect capital markets and a small open economy, Canada, let alone Ontario, can have no influence on the prevailing rate of interest. It is determined in the international economic arena. In Figure 2, this predetermined interest rate is shown as r_w (with w depicting 'world'). The equilibrium can be described as follows. Total investment in Ontario is determined by the intersection of the investment schedule with the world (and domestic) interest rate. Hence investment equals I_1. But domestic savings only equal S_0, the intersection of r_w with the savings schedule. The additional funding for investment (I_1 minus S_0) comes from foreign borrowing.

Now let us see what happens when savings increase. The SS schedule shifts to the right, to S^1S^1. There is no change in total investment, since it is still determined by the intersection of r_w and the investment schedule. But domestic savings have increased to S_1. Therefore, *more of the total investment is financed out of domestic sources and less from foreign sources*. Foreign savings have decreased from I_1 minus S_0 to I_1 minus S_1. Thus, the major impact that a change in savings has on the system under the assumption of perfect capital markets and a small open economy is that it affects the degree to which Canada is a net borrower or lender internationally. For example, should the savings schedule shift well to the right in Figure 2, such that domestic savings would exceed I_1, then Canadians would invest their savings internationally and become net lenders of funds to the world. Hence, changing the pattern of domestic savings can influence overall investment only to the extent that international capital markets are imperfect. To be sure, they *are* imperfect to a degree — this is presumably why the FOCUS model does show some impact of a change in savings on long term potential GNP (as discussed in chapter 5). Moreover, this is particularly likely to be the case for small and new business ventures, which do not have full access to domestic, let alone international, capital markets. This is the rationale for a separate chapter dealing with the impact of an Ontario PIT on savings and investment as it relates to new businesses and venture capital.

In summary, therefore, under conditions of perfect capital mobility, a general increase in savings is likely to have little impact on investment. This does not mean that there are no benefits to be derived from such an increase in savings, for it implies a decreased reliance on foreign savings and thus a greater level of wealth both now and in the future. This analysis has been conducted from the perspective of the Canadian economy; it applies with even more force on Ontario.

Figure 1:
Savings and Investment in a closed economy

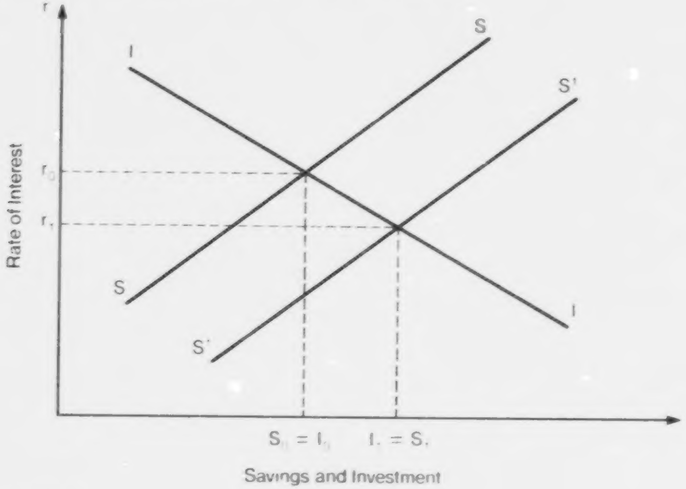
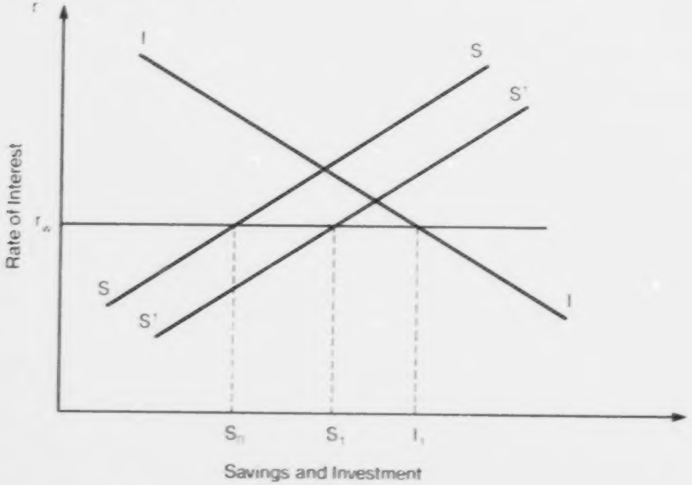

r
Rate of Interest
I
S
S'
r_0
r_1
S
I
S'
$S_0 = I_0$
$I_1 = S_1$
Savings and Investment

Figure 2:
Savings and Investment in an open economy with
perfect capital mobility.


r
Rate of Interest
I
S
S'
r_w
S
S'
I
S_0
S_1
I_1
Savings and Investment

CAN A PIT INCREASE SAVINGS?

This topic is usually addressed in terms of the difference between a comprehensive income tax and a comprehensive expenditure tax. Under a pure income tax, all sources of income would be subject to taxation. Thus, any saving would have to be done with *after-tax* income and any returns on either savings or investment would also be subject to taxation. In contrast, under a pure expenditure tax, any savings would be deductible without limit and subsequent earnings on these savings would not be taxed. Only when savings were drawn down to finance consumption expenditures would they become subject to taxation. In other words, under a comprehensive income tax, citizens are taxed on their contributions (i.e., factor incomes) to the common pool while under an expenditure tax they are taxed on their withdrawals (expenditures) from the pool. For most people, particularly over a long period of time, there is little difference between income and consumption, so the issue becomes one of the time pattern of savings and taxation.

Most PIT systems are really hybrids of these two extremes. For example, under the current Canadian regulations contributions to registered pension funds are deductible from income, the investment income arising from such plans is deferrable, and the entire sum is taxable only when received. Contributions to RHOSPs (Registered Home Ownership Savings Plans) are treated even more generously —deductible when made and tax exempt when withdrawn. There is a $1,000 investment income exemption. And so on. Compared to the U.S. system of income taxation, the Canadian system can be said to give preferable treatment to savings, whereas the American system, with its rather generalized deductibility of interest charges, probably favours spending.

Would not a further move toward an expenditure concept enhance overall savings? This question is addressed in considerable detail in the background study and in the underlying research papers. At base, it is an empirical question. While there is a voluminous literature concerning the elasticity of personal savings to market interest rates and after-tax rates of return, the overview that emerges is as follows: the evidence of the effect of taxation and tax incentives on savings is inconclusive.

DISTORTIONS AND THE SAVINGS DECISION

It is important to recognize precisely what this empirical evidence is suggesting. It is not saying that preferential treatment of pensions, for example, will have no impact on the amount of savings in the form of pensions. It clearly will have an impact. However, it is likely, or at least possible, that people will reduce *other* types of savings, so that, overall, the impact on total personal savings is uncertain.

As an example, Ontarians save more than Albertans. Is this because the latter have reduced their savings because they perceive that the heritage fund is doing some saving for them? This is the nature of the issue addressed above and the issue that the empirical work has failed to resolve in a definitive fashion.

Where the characteristics of the PIT can have a substantial influence on savings is in relation to the *form* in which citizens decide to do their saving. There exist some very important distortions in the current PIT legislation which favour some forms of savings over other forms. Some of these distortions have been alluded to above. Many others also exist. For example, home ownership is preferred as a savings vehicle because capital gains on housing are not subject to personal income taxation. Hence the major impact on savings of an Ontario-run PIT would be in influencing the *channels* through which citizens saved. By removing some existing distortions or by adding to others, it is possible to alter savings patterns. And if these savings incentives are tied to investment choices, the PIT can influence investment in certain sectors. One could go into considerable detail about the various options that might be provided by a PIT in terms of channelling savings. Rather than follow this route, our report will focus on one current example of how changes in the PIT can influence both savings and investment. This has to do with the forthcoming legislation that will remove the inflation distortion from the taxation of personal investment income. We shall deal with this in Chapter 10. First, however, we shall discuss in a rather general way the impact of the PIT on investment.

8
The PIT and corporate investment

INTRODUCTION

The question of whether an Ontario-run PIT could influence investment relates principally to whether a PIT can alter the user cost of capital. In principle, it surely can. In practice, however, the answer is less clear. The purpose of this chapter is to investigate one of the avenues by which changing the PIT provisions might alter the user cost of capital and, hence, the rate of investment, particularly corporate investment. This avenue is the manner in which dividends are treated for personal income tax purposes. The first section of the chapter reviews the current treatment of dividend income and its impact on after-tax rates of return. Next, the analysis evaluates the impact of removing the double taxation of dividends on the cost of capital. This measure is then compared with a more direct approach, namely the application of investment tax credits. A few generalizations relating to an Ontario PIT and corporate investment, as well as some comments on the interaction between a PIT and investment in the unincorporated sector, complete the chapter.

DIVIDEND TAX CREDITS

At present, corporation profits are subject to a greater overall rate of tax than other income sources. This is clear from Table 10.[1] Column 1 of the table presents the no-tax credit case, i.e., full double taxation. The $200 of corporate income is subject to a 50 per cent corporate tax and the remaining $100, assumed to be paid out in dividends, is taxed at the recipients' marginal tax rate. Hence, total corporate and personal taxes on this $200 amount to $130.

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[1] It is important to clarify the nature of the analysis in Table 10. First, it assumes that all profits are paid out in dividends, which in practice is not the case. Second, it essentially abstracts from the complex problem of corporate tax incidence. Finally, it assumes that corporations are in effect taxed at 50 per cent of their 'true' profits.

TABLE 10

Comparison of existing dividend credit system with no credit and full credit systems (assuming $200 of before-tax corporate income, CIT rate 50 per cent, PIT rate 30 per cent)

	No credit	Current dividend tax credit	Full credit
Corporate income	200	200	200
Corporate tax 50 per cent	*(100)*	*(100)*	*(100)*
After-tax personal income	100	100	100
Dividend	100	100	100
Grossed up	N/A	150[a]	200[c]
Tax at shareholders marginal rate 0.30	30	45	60
Dividend tax credit	N/A	50.0[b]	100[d]
Shareholders after-tax corporate source income	70	105	140
Total CIT and PIT revenues	130	95	60

a Dividend x 1.5.

b Grossed-up dividend x 0.3333 (new combined federal-provincial rate).

c Grossed up to equal the pre-tax value of corporate profits associated with the dividend.

d Equals the full value of corporate tax associated with the dividend.

SOURCE: Chapter 16 of background study.

Under the current system,[2] the treatment of dividends is such that there is some offset to this double taxation. This is clear from Column 2 of the table. For tax purposes, the dividend income is grossed up by one-third, for a taxable income of $150. This figure is then multiplied by the 30 per cent marginal rate (assumed for purposes of illustration), yielding a personal tax of $45. The dividend tax credit under the PIT is one-third of the grossed-up value of the dividend (i.e., $50). This leaves the 30 per cent marginal rate shareholder with $105 of net income from the $200 of before-tax corporate profit. The combined corporate and personal tax on the $200 is $95.

Under a full tax-credit system, or a complete integration of the personal and corporate tax systems, the combined tax would be $60 (see Column 3). In effect, the entire $200 is 'passed through' to the shareholder and the tax on this income is simply the PIT marginal tax rate, i.e., 30 per cent of $200 is $60. Conceptually, at least, the procedure is very simple. The $100 dividend received by the shareholder is grossed up by the amount of corporate tax paid (i.e., the $100 becomes $200, as the table indicates). This yields a personal tax level of $60. The taxpayer then receives as a dividend tax credit the full value of the corporation tax paid on the original before-tax profits for a net combined tax that equals the shareholder's marginal rate times the before-tax profits.[3]

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[2] This is not quite the current system, since there are modifications that will likely be put before Parliament as a result of the June 1982 federal budget.

This full credit system will always yield a combined tax equal to the taxpayer's marginal tax rate times the original before-tax profits, *independently of the value of the marginal tax rate*. This is not the case with the present dividend tax credit system, as the reader will realize if he reworks the analysis in Table 10 using a different marginal tax rate. The purpose of this example was to show that there are indeed some changes in the personal income tax that would increase the after-tax income for investors receiving dividend income. Obviously, there are also other avenues for making shareholders better off on an after-tax basis, but it appears to us that this is the most comprehensive modification. The after-tax increase to a 30 per cent marginal-rate shareholder is $35 (i.e., $140 – 105), for a net increase of 33-1/3 per cent. By how much is this likely to increase corporate investment? To this question we now turn.

THE INVESTMENT IMPLICATIONS OF FULL INTEGRATION

In order for a full tax credit system to influence corporate investment, the user cost of capital has to be reduced. The amount of such reduction depends on, among other things, how much share prices increase as a result of full integration. As the background study points out, the impact on corporate investment will be greater if:

1. the marginal investor (i.e., the investor that determines the share price) is a resident and has a low marginal tax rate;
2. the increase in after-tax returns on shares is fully capitalized in the price of shares; and
3. the elasticity of the demand for fixed capital with regard to the user cost of capital is large.

Problems arise, of course, if the marginal investor is an American (which is clearly possible in a small, open economy) or a resident pension fund (which will not be affected by the integration since it pays no taxes anyway), because there will then be no change in share prices. The consequence of integration under these circumstances would simply be a windfall tax saving to the shareholder.

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[3] In essence, this exercise reviews the role of a corporate tax as solely a withholding instrument. That is, it neglects the other rationales for a corporate tax, e.g., as a vehicle for taxing rents.

The background study works out the range of possible increases in share prices (reductions in the user cost of capital) and compares the most favourable results with the alternative of investment tax credits applied directly through the corporate tax system. The conclusion that emerges is that investment tax credits are:

1. more effective per dollar of revenue forgone;
2. more certain in their effect;
3. superior from an administrative compliance cost point of view.

IMPLICATIONS

This entire analysis was conducted in terms of the national tax system, not the Ontario tax system. For Ontario to attempt an integration of the corporate and personal income tax systems would be considerably more complicated, in the sense that there would have to be complex regulations relating to out-of-province, let alone foreign, investors. In addition, for there to be a decrease in the user cost of capital, the marginal investor would have to be an Ontarian. Moreover, unless the province wanted to engage overtly in beggar-thy-neighbour policies, this tax treatment for Ontario shareholders would have to apply to *all* corporate source income received by Ontario residents and not just to income from Ontario-based corporations. The net result might be that investment would be encouraged, but it would not necessarily be put in place within the province.

There is no doubt that if Ontario did have control over its own PIT, it would be in a better position to influence the overall level of corporate investment, since it could make appropriate modifications in the manner in which the Ontario PIT treated source income. Yet it also seems rather clear that it might be preferable to undertake such initiatives directly within the corporate tax system via such measures as accelerated depreciation, investment tax credits, or reductions in the corporate tax rate.

UNINCORPORATED ENTERPRISES

Thus far, the analysis in this chapter has focussed only on corporate investment. At least with respect to the rather far-reaching tax reform that we have focussed on, the message appears to be that any investment objective is better met by operating within the corporate tax system itself.[4] However, this conclusion still leaves open the question of what might be done to encourage investment in the unincorporated sector. To the extent that this is an overall goal of policy, there are greater advantages to Ontario's having its own PIT. But even here other factors should be kept in mind. First, to the extent that the recent B.C. tax credit provides a precedent, it may now be difficult for the federal government to refuse to administer an investment tax credit scheme (under the Tax Collection Agreements) that applies to unincorporated businesses. Second, even if Ottawa refuses, there always is the alternative of introducing investment credits for unincorporated businesses via a provincial expenditure program rather than through a PIT. Third, by far the most significant recent change in the taxation of personal income is now being contemplated by the federal government, i.e., adjustment of personal investment income for the inflation distortion. If introduced, this change will have an effect on the returns of both incorporated and unincorporated businesses. The proposed tax reform is dealt with in some detail in Chapter 10.

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[4] We again remind the reader that there probably exist avenues for PIT change whose results would be more favourable in terms of the effect on overall investment.

Despite these provisos, it is nonetheless still the case that if the province wants symmetry of treatment of its corporate and unincorporated enterprises, this symmetry can best be delivered through an independent PIT. But this is a statement that abstracts from the costs that would be associated with achieving this symmetry.

9

The PIT and new and small enterprises

INTRODUCTION

All governments have programs for lending support to new and small enterprises. A catalogue of these programs for Ontario, Quebec, and the federal government can be found in a recent Council-sponsored publication, *Industrial Policy in Ontario and Quebec*.[1] For the purpose of this report, the question at issue is whether or not the existing range of programs is adequate. To phrase that question somewhat differently, could the added flexibility that would accompany a separate Ontario PIT provide a new and significant vehicle for delivering aid to small businesses and venture capital enterprises?

The rationale for government intervention in the small business area is presumably related to market failure or market imperfection — new and small firms simply do not have the access to funds that larger and established enterprises do; they are typically high risk ventures, and the inadequate treatment of capital losses under the present tax system impedes the flow of investment in their direction;[2] the existing tax measures, such as RRSPs, RHOSPs, etc., provide highly attractive alternatives to direct savings, thereby reducing the flow of funds into new ventures; and so on. It is beyond our mandate to sort out the issue of whether or not new enterprises deserve special treatment. Rather, we simply accept the prevailing wisdom that these sectors do merit special treatment and restrict ourselves to the issue of whether an independent PIT would make a more effective avenue for delivering this aid. Presumably, this special treatment could run the gamut from tax credits to preferential tax treatment (e.g., in terms of tax rates) for savings channelled in the direction of venture capital firms. The introduction of tax credits for this purpose need not imply a withdrawal from the Tax Collection Agreements if, as the federal government's acceptance of the new B.C. tax credit seems to suggest, Ottawa is now willing to administer such credits under the existing arrangements. But the introduction of such measures as different tax rates for certain types of investment income would probably require Ontario to go its own way on the PIT.

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[1] P. Davenport, C. Green, W.J. Milne, R. Saunders, and W. Watson, *Industrial Policy in Ontario and Quebec*, Discussion Paper Series (Toronto: Ontario Economic Council, 1982).

[2] The proposed RSIP scheme, with its altered loss offset provision, should help in this regard. See Chapter 10.

The analysis focusses on one of the principal existing provincial programs for delivering aid to new and small ventures—the Small Business Development Corporations Program.[3] The question is whether an alternative program run through a separate PIT would deliver aid more effectively. Partly because the SBDC program is only a couple of years old, the Council is unable to come to any firm conclusion, but it appears to us that there is not that much to be gained in this area via a separate PIT.

THE SMALL BUSINESS DEVELOPMENT CORPORATIONS PROGRAM

In 1979, Ontario introduced the Small Business Development Corporations Act. The aim of the legislation was to increase the supply of venture capital and managerial expertise to small businesses and to ensure the existence of a ready stream of equity capital available to new enterprises. The act provides for incentives of a value equal to 30 per cent of the investment in SBDCs, which are basically venture capital companies. In turn, the SBDC must invest in businesses under a certain size in specified areas, such as manufacturing. The many regulations surrounding the activities of SBDCs, while critical to the likely success of the program, are far too detailed to explore here.[4]

The 30 per cent investment incentive is provided to corporations in the form of a tax credit and to individuals in the form of a grant. Presumably, if Ontario had its own PIT, the incentive to individuals could also be delivered in the form of a tax credit. However, it is not clear that this would be as effective as the grant. Ontario officials claim that grant cheques are issued within fifteen working days after an application is approved. By contrast, a tax credit could take over a year to be returned to an individual, assuming that there was tax payable that year. Perhaps as a result, the available data indicate overwhelmingly that the incentives have been taken up by individuals rather than by corporations. One recent study indicated that $32 million in grants have been approved, compared with $2 million in corporate tax credits. With the new corporate tax holiday for small businesses in Ontario, many potential corporate investors in SBDCs will find the tax credit of little use, since they will have no Ontario corporate tax owing.

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[3] There are, of course, numerous other programs designed to aid small businesses. For example, Small Business Bonds allow enterprises to reduce their borrowing costs by treating interest payments as dividends. Hence, a small business can float debt with a lower interest rate. The fact that the interest is non-deductible is not a problem for those small corporations that do not have net income against which to deduct interest expenses. Another important recent measure is the two-year provincial tax holiday for small corporations. However, we are restricting our focus to those measures that tend to be substitutes for programs that could be implemented through a separate PIT, and in this context, the Small Business Development Corporations Program is more pertinent than, say, the two-year corporate tax holiday.

[4] The interested reader can obtain much of this detail from Chapter 13 of the background study.

Obviously, the tax treatment of this grant is critical to the operation of the program. Ontario was successful in its negotiations with the federal government on this score — the grant is not taxable under the PIT.[5] Indeed, the province may have the best of both worlds. If it had its own PIT, any provincial grants to citizens would obviously not be taxable for provincial purposes, but they might be counted as income for federal purposes. The SBDC grant is exempt from taxation at both levels. However, as the background study points out, while the current federal tax treatment is very helpful, it is difficult to predict what the future will hold.[6]

On a more general level, it can be argued that one advantage of a system of PIT investment credits is that an investor can normally choose where (i.e. in which companies) any investment is made. By contrast, under some government expenditure programs in the small and new business area the government 'selects' the recipient. However, the SBDCs are at arm's length from the government, and they make the decisions as to where the investment should go. Hence, on this score as well, a separate PIT would have little advantage.

THE QUEBEC APPROACH

If the PIT were especially effective as an avenue for delivering aid to small business, then one would expect to see it used for this purpose by Quebec, which has its own PIT. As was noted on several occasions earlier in this report, Quebec did introduce its Stock Savings Plan in 1979. Nonetheless, it too has developed a series of small business programs *outside* the personal tax system. It is not entirely clear whether the PIT and non-PIT programs each have a job to do or whether the non-PIT approach is regarded as preferable. Our tentative conclusion is that the mere existence of the Quebec small business development program indicates that PIT programs are not viewed as good substitutes for the full range of activities required to aid small business.

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[5] However, the grant is taken into account if the taxpayer is claiming a capital loss — it reduces the loss up to the amount of the grant.

[6] To underscore this, it is worth noting that the SBDC legislation replaced the old Venture Investment Corporation Registration Act. There are several reasons why this former piece of legislation was not successful, among them the fact that the federal government did not give preferential tax treatment.

IMPLICATIONS

The SBDC program is only in its infancy, so it is difficult to evaluate its success with any degree of certainty. In general, however, we feel that the benefits to be derived from an enhanced ability to deliver investment incentives appear marginal and do not provide much support for the establishment of a separate personal income tax system in Ontario. To a considerable degree, this assessment has been influenced by the fact that where expenditure programs (like the SBDC) have been introduced as substitutes for programs run through the federal tax collection system, *they have very often been able to escape federal taxation*. Indeed, these may not be independent events—*the federal government may be willing to grant special tax privileges for these expenditure programs as the price for maintaining the Tax Collection Agreements relatively intact*. Were these tax privileges not available, the advantages of implementing support via a separate PIT would be enhanced.

10

The PIT and the inflation distortion: the federal tax reforms

INTRODUCTION

Given the emphasis to this point on small, open economies, perfect capital markets, the nationality of the marginal investor, etc., the reader is likely to come away with the perception that the PIT does not matter much when it comes to the issues of investment and efficiency. That this is probably not the case should become evident in the following analysis, which focusses on the proposed federal reforms relating to the personal income tax treatment of investment income, and particularly the inflation component of investment income. The original federal proposals were contained in a discussion paper (referred to hereafter as the federal white paper) released in connection with the June 1982 federal budget.[1] At about the same time as the publication of the white paper, the Minister of Finance struck a Ministerial Advisory Committee to evaluate the proposals. The committee reported[2] at the end of September, and the recommendations contained in the report (henceforth referred to as the Lortie Report, after its chairman Pierre Lortie) have been accepted by the new federal Minister of Finance, Marc Lalonde. The Ontario Economic Council also played a role in this reform process. During the summer of 1982, it commissioned several studies on the reform package. These studies, along with the comments of several discussants, appeared as a Council technical study.[3]

In the Council's view, the white paper proposals constituted one of the most significant attempts at personal income tax reform in the post-war period. Hence, we went the further step and issued a Council position paper on the general issue.[4].

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[1] Allan J. MacEachen, *Inflation and the Taxation of Personal Investment Income* (Ottawa: Department of Finance, 1982).

[2] Pierre Lortie *et al.*, *Report of the Ministerial Advisory Committee on Inflation and the Taxation of Personal Investment Income* (Ottawa: Ministry of Supply and Services, 1982).

[3] D.W. Conklin, ed., *Inflation and the Taxation of Personal Investment Income: An Analysis and Evaluation of the Canadian 1982 Reform Proposals* (Toronto: Ontario Economic Council, 1982).

[4] *Inflation and the Taxation of Personal Investment Income: An Ontario Economic Council Position Paper on the Canadian 1982 Reform Proposals* (Toronto: Ontario Economic Council, 1982).

Thus, our views on the reform proposals are already in the public domain. However, given the fact that these proposals are so intimately connected with the question of a separate Ontario PIT, it is necessary to devote some space to an elaboration of the issues.

The first part of the chapter will focus on the manner in which the interaction of inflation and the PIT distorts the allocation of investment capital. Next we shall discuss the white paper proposals and the counter-proposals embodied in the Lortie Report. After an evaluation of the Lortie Report's recommendations, we shall attempt to place the analysis in the context of the central aspect of the present report — namely, the implications it has for a separate Ontario PIT. Because our views on most of these issues are available elsewhere, the analysis will be rather brief.

THE INFLATION DISTORTION IN THE PIT TREATMENT OF INVESTMENT INCOME[5]

The white paper presents both analyses and examples to show that, as a result of the interaction of inflation and the personal income tax system, the real (after-inflation) return on debt and equity instruments can easily be negative, since investors are required to pay tax on the inflation component of the investment return.[6] This is an 'illusory' gain and should not be subject to taxation, since a return equal to the rate of inflation is required simply to keep the real value of the investment unchanged from year to year. Only any interest income or capital gain *above* the rate of inflation should be counted as income for tax purposes. The white paper's solution to this distortion, at least for equities, was the Registered Shareholder Investment Plan (RSIP) program. Share gains would retain their current preferential treatment (i.e., one-half of capital gains would be taxed at marginal rates), but now only the after-inflation component of a share price increase would be viewed as a capital gain.

Under inflationary conditions, the present tax system also generates problems for borrowers. These problems are of two sorts. The first relates to the very serious liquidity bind which borrowers can experience when inflation accelerates. Consider homeowners, for example. Because of inflation, the real value of a typical homeowner's outstanding mortgage has fallen while the real value of his home has remained unchanged (assuming that the housing price increases match those of prices generally). Thus, his net equity has increased. However, when mortgage renewal time coincides with higher inflation and higher nominal interest rates, the homeowner will be called upon to make substantially higher cash payments under the terms of the new mortgage. Inflation has made the homeowner house-rich but liquidity poor. An indexed mortgage—with repayments in real terms designed to remain constant over the period of the mortgage—would solve this problem. Conventional mortgages under rising inflation imply that homeowners are paying off their real mortgages at a very accelerated rate. To be sure, this problem is related more to the non-existence of real term contracts (in this case, real term mortgages), but to the extent that real term contracting is inhibited by the current income tax provisions it becomes a PIT problem.

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[5] Some of the analysis in this chapter is adopted from a recent paper by Thomas J. Courchene and David C. Smith, 'Inflation Indexation and Capital Income: What's Left of the White Paper', forthcoming in the Canadian Tax Foundation's Annual Conference Volume.

[6] It should be noted that the $1,000 investment income exemption and the tax treatment for capital gains on equities represent a partial offset to this problem and in some cases, such as for small investors, a full offset.

A second sort of problem has been of even greater concern in recent years. While all borrowers may face the same high nominal interest rates, the real, after-tax rates of interest faced by various borrowers differ markedly. For example, with market (nominal) interest rates at 18 per cent and with inflation running at 12 per cent, the real, after-tax rate of interest is 6 per cent for those borrowers who cannot deduct interest payments for tax purposes (e.g., homeowners and businesses with no profits). On the other hand, for large profit-making corporations (in the 50 per cent tax bracket), the after-tax cost of borrowing is 9 per cent, for a real, after-tax, cost of funds of minus 3 per cent. For profitable small businesses (25 per cent tax rate), the after-tax real interest rate is about 2 per cent. Thus, there are very significant differences in the manner in which high nominal interest rates affect the various sectors of the economy. The white paper proposals designed to deal with this uneven sectoral impact involved the creation of a new type of deposit—an Indexed Term Deposit (or ITD) that would carry a real rate of return; the holder would be taxed only on this real return (i.e., no taxation of the inflation component). There would also be a corresponding Indexed Term Loan (ITL), which would be available to certain selected borrowers (e.g., new homebuyers and purchasers of new depreciable property in certain sectors). Because of the special features of the ITD (real-term contracting and the tax treatment of the inflation component of interest), it would bear a real rate of interest considerably below that of current market instruments, and this lower rate would be passed on to the preferred borrowers by means of the ITLs.

THE LORTIE REPORT

The Lortie Report gave a green light to the RSIP proposal. The federal Minister of Finance has accepted this recommendation, and the associated legislation will likely be tabled in Parliament in early 1983. What consequences are likely to arise from this tax reform? First, the rate of return on equity investment will surely rise, and rise substantially. This result will stem from two sources: (1) the new tax treatment whereby only increases in equity values above the rate of inflation will be subject to capital gains tax, and (2) the symmetrical treatment of capital gains and capital losses. Under the existing legislation, net capital losses are limited to $2,000 per year. Under the RSIP scheme, there will be no limit if the investor opts for a full accrual treatment of gains and losses. Thus, not only will savers be attracted toward equities and away from other avenues of savings, but the new loss offset treatment will encourage investment in more risky equities. Second, the user cost of capital could decline considerably. The extent to which it declines will, of course, depend upon who is the marginal investor, etc. (as was discussed in the previous chapter), but the likelihood is that the decline will be sufficient to provide a boost for equity markets. In short, the exact nature of PIT provisions *do* matter, not only for the volume of investment but also for the sectoral allocation of savings.

With respect to the ITD-ITL proposals, the Lortie Report recommended that they not be implemented in the manner suggested by the white paper. It noted that a comprehensive approach to the overall problem of taxation of investment income would require changes in the treatment of business income as well as personal investment income. Since reform of business income taxation was beyond its mandate, the Lortie Committee recommended that the federal government initiate a special study to contemplate these more sweeping changes. The federal Finance Minister accepted this recommendation and work is now in progress at the Department of Finance in Ottawa to pave the way for this more comprehensive reform.

It is instructive to focus on the Lortie Report's reasoning with respect to the ITL-ITD proposal. The committee recognized (and so did the Council in its document) that while the proposal would do much to remove distortions arising from the interaction of inflation with the personal income tax system, it would also introduce some new distortions:

—It would distort the allocation of resources between those sectors eligible to use the loans (e.g., housing, fishing, farming) and those not eligible.

—Distortions would also occur *within* the favoured sectors themselves. With respect to housing, for example, the ITLs would only be available for new homes. This would drive a significant price wedge between new and old houses and thereby generate arbitrary windfall gains and losses.

—The proposal represented a potential for substantial new government intrusion in the operations of financial institutions and in the allocation of credit. Taken to its limit, this could mean that eligibility for the ITLs would be determined on political rather than economic grounds.

For the purposes of the present study, the detailed reasoning of the Lortie Report is not all that important. (Although it is perhaps interesting to note that the OEC's position on the ITL-ITD issue was that the proposal should go forward provided that it was broadened—broadened to extend the range of eligible borrowers, broadened to extend the range of uses to which the borrowed funds could be put, and broadened to extend the range of financial instruments which qualified for the special tax treatment.) Rather, the important point is that the personal income tax treatment of financial instruments does matter. Indeed, it matters so much that both the Lortie Report and the OEC were fearful of the implications of a straightforward adoption of the white paper proposals.

IMPLICATIONS FOR A SEPARATE ONTARIO PIT

How does this analysis, brief as it has had to be, relate to the issue of the costs and benefits of a separate Ontario PIT? In fact, several pertinent implications arise from the foregoing discussion and, as will be seen, they span quite a spectrum. First of all, it is clear that the provisions in a PIT relating to the taxation of investment income *do* matter a great deal. They matter not only in terms of their effect on the volume of investment, particularly where markets are less than perfect, but they also have a major influence on individuals' choices of the channels through which they do their saving. It is, or should be, very evident that the RSIP scheme will tilt savers in the direction of equities and also in the direction of favouring more risky equity investments than was hitherto the case.

The second observation may appear somewhat dated. When the Council received the PIT Reference from the Treasurer (in May of 1982), one of our earliest thoughts regarding the possible positive contributions of an Ontario PIT related to the fact that there might be some reforms which would be conducive to achieving both efficiency and equity. This being the case, they might well also be adopted by the federal government and established nationally. And the one area where the Council felt that the province might influence the overall system was precisely with respect to the treatment of personal investment income. The move by the federal authorities in this area has, of course, co-opted this particular rationale. However, the general principle remains, in the sense that there are probably other areas of the PIT where provincial experimentation could be successful enough to encourage Ottawa to adopt similar provisions at the national level.

The third implication really derives from the above analysis. There may indeed be solid reasons for Ontario to go its own way with respect to a PIT. However, in the immediate future, by far the most important activity for the Ontario Treasury is to involve itself to the fullest in the forthcoming federal study on inflation and the taxation of business and personal investment income. This presents a marvellous opportunity for the province to get its views across to Ottawa with respect not only to the personal income tax system but to the corporate tax system as well.

The final implication the Council wishes to draw from this tax reform exercise relates to a subject which will be the concern of a later chapter, namely the degree to which there is federal-provincial consultation prior to major modifications in the personal income tax provisions. As was noted in Chapter 1, the provinces that participate in Tax Collection Agreements are required to introduce into their own PITs any changes which Ottawa deems desirable. In the Council's correspondence with several provinces, relative to this reference, the message we received loud and clear was that the federal government views the PIT as its *own* field. Certainly, the trial balloons recently floated from Ottawa relating to the spousal exemption and the exemptions for children are ample evidence of this. Frequently, there is little, if any, discussion with the provinces prior to a major federal change in the PIT provisions. This was clearly the case with the federal proposals with respect to inflation. The provinces were not consulted prior to the white paper, even though one result of its proposals would be to reduce provincial PIT revenues in a rather drastic fashion. The fact that the provinces might agree with the general thrust of the reform does not detract from the principle at issue. It is hard to come away from all of this without the view that Ottawa perceives the structure of the personal income tax as something that falls entirely within its own domain of action. The provinces do have a right to respond to any proposed amendments (if the federal government allows any such public discussion of its proposals), but in this process they are treated like any other special interest group. This is precisely the attitude taken by the federal government that is most likely to spawn separate PITs across several provinces. The Council finds it somewhat ironic that after it was given the Treasurer's Reference, part of which relates to the lack of provincial input into the overall PIT structure, the federal government embarked on a process of PIT reform that shut the provinces out completely.

Part II: Council summary observations

—The structure of the personal income tax plays a significant role in the achievement of economic growth and allocative efficiency.

—With respect to labour supply and quality, a separate PIT might play a role that would be conducive to enhancing the province's growth prospects, but in general there are alternative ways to achieve these goals.

—In a small open economy, the principal impact of an increase in domestic savings is to alter the reliance on foreign savings. However, it is clear that the provisions of a separate PIT can have a substantial influence on peoples' choices of the channels through which they save. Moreover, by channelling savings to areas where capital markets do not function well, a PIT can have an influence on investment and growth.

—The PIT treatment can have a considerable influence on the returns to corporate investment. The analysis discussed in detail only one possible modification —the integration of the corporate and personal tax systems in order to remove the double taxation of dividend income. With sufficient capital market imperfection, such an integration can enhance the overall level of investment. However, considerable uncertainty attaches to these results, and if it were adopted only at the provincial level such an integration would generate substantial complexities in the PIT structure. In general, it would appear that Ontario can achieve the same goals by appropriate modifications in the corporate tax system.

—There is a greater role for a PIT in affecting the flow of funds to small businesses and venture capital firms. Special tax treatment of investment income from these sources would channel more funds in their direction. However, the Council's view is that the present legislation relating to the SBDCs and Small Business Bonds already plays a valuable role in this area. It is not evident that the additional leverage obtainable through a separate PIT would justify a move away from the Tax Collection Agreements.

—That the PIT can influence both savings and investment appears very evident from the analysis of the proposed federal reforms to correct the PIT for the inflation distortion. The Council feels that it is imperative that the Ontario Treasury take a very active role in the forthcoming reform process, particularly the proposed study of the tax treatment of personal and business investment income. We view these proposals as constituting one of the most fundamental reforms of the tax system in the post-war period. Only when the reforms are implemented will it be possible to assess what further advantages would accrue to the province from adopting an independent PIT.

PART III
Stabilization Policy

11

The PIT and stabilization policy

INTRODUCTION

For the purposes of our report, we take a rather broad view of stabilization policy. It is assumed to encompass not only the use of policy instruments to iron out economic fluctuations but also attempts (including sector-specific policies) to improve economic performance with respect to the broad macro-objectives of full employment, price stability, and adequate economic growth. Since we are accepting multiple objectives for stabilization policy, the task of stabilization requires multiple instruments. The effectiveness with which multiple objectives can be attained will, in general, increase as the number of policy instruments increases. As the background study points out, however, it is possible for a prospective policy instrument to be dominated by a combination of existing instruments with the result that the addition of such a policy instrument would not improve the overall effectiveness of stabilization policy. In this light, the purpose of the present part of the report is to appraise the role of the province in stabilization policy and, what is more important, to consider the impact of a separate personal income tax on the potential effectiveness of provincial stabilization policy. We shall deal with the former matter first.

THE ROLE OF PROVINCIAL STABILIZATION POLICY

In most people's minds, stabilization policy is a role that falls principally to the federal government. For one thing, monetary policy, one of the two 'big levers' of stabilization policy, is assigned to the federal government under the constitution. But there is also a sound economic argument, based on the existence of externalities, that lends support to federal supremacy in stabilization policy. The argument goes as follows. Efforts at the provincial level to stabilize the economy will have 'spillovers', or external effects that will be felt outside the province. For example, suppose Ontario were to increase its government expenditures in response to a downturn of economic activity. Some of this benefit would spill over into other jurisdictions. In deciding how much to spend on the stabilization function, Ontario would typically not include these external benefits in any calculation, the net effect of which would be that, from a national perspective, too little activity would be devoted to stabilization. Alternatively, if the province attempted to retain the benefits of any pump-priming activity entirely within its own jurisdiction, this could lead to beggar-thy-neighbour policies and a serious fracturing of the internal common market. Hence, there are sound reasons for assigning principal responsibility for fiscal policy to the federal government.

It does not follow from this that there is no role for provincial stabilization policies. The economic structures of our regional economies are quite varied. This would suggest that at any given point in time the stance of fiscal policy appropriate for one region may be very different from what would be appropriate elsewhere in the country. Political constraints being what they are, there is not much scope for regionally discriminating fiscal or stabilization policies at the federal level, although one can point to a few examples of such policies over the past decade (e.g., regionally differentiated unemployment insurance benefits, DREE, regionally differentiated investment tax credits). It follows, then, that the use of provincial fiscal policies as an adjunct to federal policy can improve the performance of overall stabilization policy as well as have a positive impact on the well-being of the particular provinces.

THE SCOPE FOR STABILIZATION POLICY IN ONTARIO

Given that there is a useful role for provincial stabilization policies from both a national and a provincial perspective, the obvious next question is whether or not such policies are likely to be effective. This is basically an issue of whether or not the provinces are so small and so open that the spillovers into other jurisdictions are simply too large to justify an active provincial stabilization role. The chapter on stabilization in the background study investigates this issue (with the help of the University of Toronto's FOCUS/PRISM econometric model) in some detail. Without claiming that these results will carry over to other provinces, the background study offers the following conclusions with respect to stabilization policy for Ontario.

1. While the income multipliers for fiscal action are typically somewhat smaller than their national counterparts, the multipliers are not so low as to render provincial policy ineffective, particularly under a floating exchange rate regime.
2. The multiplier effects of government capital expenditure changes are considerably larger than the corresponding effects of equivalent general income tax

changes. What this implies is that general income tax changes are likely to be less effective than selective measures, such as sales tax changes focussed on Ontario products or, perhaps, the types of selective tax changes that would be possible with a separate PIT.

It should be noted that these generalizations, except for the reference to a separate PIT, are not that different from the conclusions of Clarence L. Barber's study of Ontario fiscal policy, which was commissioned in the mid-1960s.[1] With this as a backdrop, we can now proceed to evaluate whether an Ontario-run PIT would enhance its stabilization role.

A SEPARATE PIT AND PROVINCIAL STABILIZATION POLICY

While the existing array of instruments is doubtless adequate for the purpose of stimulating or reducing real aggregate demand in the province, there do exist a number of problems with the existing joint PIT system (in dealing with these we shall be drawing almost verbatim from the background study).

First, it is difficult if not impossible to treat corporate and unincorporated enterprises neutrally. As a result, provincial tax initiatives designed to stimulate business investment are applicable only to the corporate sector. Two examples are provided in the recent provincial budget:

1. The province has refused to follow the federal lead in limiting first year capital cost allowance deductions. However, in the absence of a separate PIT, the province's action can only apply at the corporate level. Unincorporated enterprises and individuals with property income cannot avail themselves of this benefit.
2. To provide some relief from the current recession, a two-year tax holiday was declared for small incorporated enterprises. This amounts to an effective tax reduction of 10 percentage points for those enterprises. A similar tax reduction for unincorporated enterprises is of course not feasible under the existing joint PIT system.

With either a separate PIT or a more flexible joint system, this type of non-neutral treatment of corporate and unincorporated enterprises could be avoided. It should be clear to the reader that this question of neutrality is not limited to the stabilization implications of a separate PIT. For example, it is also of considerable importance to the issue of income distribution, the subject of the following chapter.

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[1] Clarence L. Barber, *Theory of Fiscal Policy as Applied to a Province*, The Ontario Committee on Taxation (Toronto: Queen's Printer, 1966).

Second, the existing joint system forces the province to automatically adopt federal tax measures that may be undesirable from the provincial standpoint. For example, as a leading producer of capital equipment, Ontario may favour an investment stimulus over government spending as a means of combating recession. If the federal government adopts the opposite policy, as has occurred over the past year, the federal PIT measures that adversely affect investment *automatically* apply to the provincial component of the joint PIT, thereby *reinforcing* the very effect of federal measures that are undesirable from the province's standpoint. A separate PIT would eliminate this problem, and a more flexible joint system could lessen it.

More generally, it is clear that increased flexibility in policy design would permit some improvement in the effectiveness of provincial fiscal policies in dealing with multiple objectives of stabilization policy. How important this improvement is cannot be readily determined, because it depends on the state of the national and provincial economies, and upon the impact of federal actions on the Ontario economy. For example, if there were little problem of conflict between the objectives, and if the performance of the Ontario economy closely paralleled that of the rest of the country, there would be little advantage to increased flexibility of policies at the provincial level, provided that federal policies were appropriate. In this situation, the piggy-backing of Ontario tax changes on federal tax changes could well be sufficient for stabilization purposes.

An opposite example would be a situation in which Ontario's growth prospects were much weaker than the rest of Canada's, with investment strong in the West and/or East and weak in Ontario. Under these circumstances, a regionally neutral fiscal policy initiated at the federal level might not be optimal. If political concerns or constitutional constraints limited the adoption of regionally discriminatory federal policies, a flexible Ontario fiscal policy would permit the province to provide appropriate stimulus to capital investment, should it so desire.

A SEPARATE PIT AND FEDERAL STABILIZATION POLICY

Thus far, attention has been directed to the potential of a separate PIT for enhancing provincial stabilization policy. However, a separate Ontario PIT would also have major implications for the conduct of federal stabilization policy. Specifically, a separate provincial PIT would reduce the *leverage* of any federal tax change that affected 'basic federal tax' (e.g., changes in deductions, income definitions, indexing, dividend integration). This is so because changes initiated at the federal level would no longer be automatically carried over into the provincial PIT structures.

In the extreme, one could argue that the existing shared PIT system biases the federal government's choice towards stabilization measures that apply leverage at the provincial level (i.e., that force the provinces to follow suit). For example, in a recession a tax cut that decreases basic federal tax may be preferred to a cut in other federal taxes, since *the federal government can achieve the same aggregate demand impact with an income tax cut but with the important difference that an income tax change has only two-thirds of the impact on the federal deficit—the other third of the deficit occurs at the provincial level*. This circumstance may bias expansionary federal fiscal policy to take the form of reducing federal basic tax and bias restrictive federal policy to take the form of increasing taxes that fall solely under federal jurisdiction. The other side of this coin is, of course, that if the provinces are in favour of such a tax cut, they can reap the benefits and still blame Ottawa when it comes to explaining the resulting provincial deficit to their voting citizens.

It might be argued that it would be far better to remove this controversial leverage completely. This could be accomplished in two ways. One obvious way would be for Ontario to opt for its own PIT. Then leverage would exist only if Ontario decided to go along with the federal tax changes. An intermediate step would be an understanding between the federal government and the provinces that the former would not introduce structural changes that affected 'basic federal tax' without full consultation with the provinces. An agreement of this nature would preclude the federal government from tinkering with such features of the tax system as indexing, the capital cost allowance, and income averaging without provincial consultation. Yet it would not seriously hamper the federal government, which could use federal income tax credits and surtaxes to implement its stabilization policies without having to alter basic federal tax. Obviously, if the provinces welcomed the changes, they could then be introduced into the basic structure of the tax system. This more flexible joint PIT system as an alternative to separate provincial PITs will be developed in more detail in Chapter 18, which surveys the range of alternatives to the present personal income taxation arrangements.

THE PERVERSITY HYPOTHESIS

We cannot take leave of the discussion of provincial stabilization policy without some reference to a long-standing strand of the public finance literature known as the 'perversity hypothesis'. The hypothesis is that sub-national governments with no direct access to the central bank and with restricted access to taxation will put considerable emphasis on things such as budget balancing and creditworthiness. Hence, in a recession these units might respond by raising taxes or cutting expenditures, thereby exacerbating the recession (i.e., they will act 'perversely' or procyclically) as was indeed the case in the 1930s, although federal stabilization policy in this period was equally flawed. The Carter Commission looked into this issue and concluded that while there was plenty of room for improvement in stabilization policy at both levels of government, the provinces had not (in the 1950s) behaved in a cyclically perverse manner. In general, the perversity hypothesis would appear to be more appropriate to a federation composed of very small sub-national units than to Canada.

It is still possible, however, that the politics of tax changes could worsen overall stabilization policy under a regime of separate PITs. For example, under the current arrangements the provinces might accept a federally initiated PIT tax increase but they would not proceed with such an increase on their own. The argument here boils down to the fact that a provincial treasurer can duck accountability under the present arrangements, but would have to shoulder the responsibility under a separate PIT. The general issue of the politics of a separate PIT will be discussed in Chapter 17.

The Council recognizes the possibility of provincially perverse stabilization policies but does not assign it much importance.

Part III: Council summary observations

—The Council believes that the principal responsibility for stabilization policy has to reside at the federal level.

—Nonetheless, there is an important provincial role in stabilization policy. This is particularly the case for jurisdictions as large as Ontario.

—With the significant difference in economic structures across regions and the political limitations of regionally differentiating federal fiscal policy, the role of provincial stabilization policies becomes more important.

—As a result, it is entirely possible for overall federal policies to be in conflict with the stabilization needs of Ontario. When this is the case, the existing PIT system magnifies the degree of inappropriateness, since Ontario has to parallel the federal changes in its own PIT.

—A separate PIT would remove this problem and would provide Ontario with additional flexibility to achieve the multiple goals of stabilization policy. One obvious advantage would be that Ontario could provide equivalent treatment for the corporate and unincorporated sectors.

—A separate PIT would also have an impact on federal stabilization policy. In particular, it would remove Ottawa's present 'leverage', which it can use to force the provinces to share some of the burdens (and some of the benefits as well) of stabilization measures undertaken via PIT changes.

—If leverage is a problem, it can be handled through increased federal-provincial cooperation and consultation relating to proposed changes in the common PIT structure. Or it can be handled by having the federal government introduce tax changes by means of federal tax credits (i.e., leaving 'basic federal tax' unchanged).

—While it appears that a separate PIT could provide some advantages with respect to stabilization policy, it is nonetheless the case that, in general, measures relating to expenditure changes are more effective in influencing aggregate demand than measures undertaken through general tax changes.

PART IV
Income Distribution

12

The PIT and the distribution of income

INTRODUCTION

In terms of activities such as encouraging efficiency and increasing the effectiveness of stabilization policy, the potential benefits of going the independent PIT route are typically circumscribed. The evidence is usually far from overwhelming that a separate PIT would contribute significantly to achieving the goal in question, and where the evidence does tend to be rather convincing there are typically other, non-PIT routes available that appear to be equally effective. However, this does not appear to be the case with respect to income distribution. Even given the obvious, namely that the structure of the personal income tax is only one of many policies that influence the overall distribution of income (others include the range of expenditure programs, social programs such as medicare and welfare, and the system of other taxes and transfers), it would appear that a separate PIT could considerably increase a province's flexibility in this area. In this chapter we focus first on the constraints that exist under the present arrangements and then on the additional degree of freedom that would attend a separate PIT. The final section of the chapter will deal with alternative PIT structural arrangements which might deliver this added flexibility without forcing provinces to the extreme of going it alone with respect to personal income taxation.

THE LIMITS OF THE CURRENT SYSTEM

To describe some of the constraints imposed by the present arrangements is, of course, to describe the increased flexibility that would be attained through a separate PIT. Thus, there can be no clear distinction between this section and the following one. With this in mind, the first area we turn to is the degree of progressivity of the tax system. The existing joint PIT system makes it difficult for a province to alter its general tax level without also altering the degree of progressivity of provincial income taxes. This occurs because provincial taxes are calculated as a percentage of federal taxes—an increase in the provincial tax rate automatically increases progressivity and vice versa. Thus, whatever the underlying degree of progressivity in the federal rate structure, it will be magnified by provincial tax increases.

One can, of course, argue that the real situation is not quite as problematic as the one portrayed above, since the provinces are allowed to mount tax credits in the form of tax surcharges or tax cuts (see Chapter 2). This does give the provinces some flexibility in terms of their ability to determine the overall progressivity of the system, although any comprehensive attempt to alter progressivity by this avenue would prove extremely cumbersome.

The issue of progressivity essentially relates to the public finance concept of vertical equity, namely the different treatment of differently situated persons. Horizontal equity (the like treatment of similarly situated individuals) is also a normal goal of a tax system. As the previous chapter made clear, the lack of flexibility under the present PIT means that Ontario cannot provide comparable treatment for incorporated and unincorporated enterprises. With an independent PIT, the tax system could be neutral with respect to these types of enterprises.

THE FLEXIBILITY OF AN INDEPENDENT PIT

If Ontario operated its own PIT, it could adapt its own tax structure to its distributional goals right from the definition of income and allowable exemptions through to the rate structure and width of the tax brackets. If it so desired, the province could opt for a flat rate tax, in which case there would be no need to worry about such things as indexing brackets for inflation. Indeed, there would be no need for brackets! There is little need to go into detail here, since the reader is as able as we are to generate alternative PIT regimes that could be implemented.

Given a separate Ontario PIT, it is likely that the federal government would lose some control over income distribution. However, it is hard to make much of this point. Ottawa would still set the rate structure for two-thirds of the system, and current aggregate marginal rates already differ considerably across provinces (see Table 3).

ALTERNATIVES TO A SEPARATE PIT: 'TAX ON BASE' VS. 'TAX ON TAX'

Need a province go to a separate PIT in order to gain more flexibility in terms of influencing the distribution of income and marginal tax rates? The answer is no. To see this, it is important to recall the discussion in Chapter 1 to the effect that the present system is a 'tax on tax' system—provincial taxes are a percentage of federal taxes. An alternative would be a 'tax on base', that is, the provinces would be allowed to set their own tax rates and tax brackets and to apply these directly to the *same base* that is utilized for the federal rate and bracket structure. The system would still maintain most of the present degree of tax harmony, since there would be a *common definition of taxable income* (i.e., common income definitions, common exemptions, etc.). However, the provinces would now have far greater flexibility. Moreover, their revenues would be unaffected by changes in federal tax rates, since provincial revenues would no longer be calculated on the basis of federal collections.

This concept of 'tax on base' or 'tax on income', as distinct from the present 'tax on tax', is not entirely new. It has been advocated in the past by the Province of Manitoba. More recently, former Finance Minister MacEachen noted:

> There may be some interest in the provinces in establishing more than one rate of personal income tax and additional rates for corporations (for those provinces still in the Tax Collection Agreement for corporations). *In the case of the personal income tax, some provinces might prefer to levy their tax on federal 'taxable income' rather than 'basic federal tax'*. In the case of corporations, provinces might wish to offer special manufacturing and/or processing rates. These would, however, complicate the tax system, be very difficult to administer and would result in loss of uniformity.[1]

With respect to the personal income tax, the problems cited in the last section of the quote appear to be somewhat exaggerated. For example, under a flat rate provincial tax only one calculation would be needed to obtain provincial taxes payable—exactly the present situation. The administration costs would also be identical. To be sure, some complexities would arise if rate structures became more elaborate and markedly different across provinces. With respect to the tax harmony issue, the 'tax on base' would maintain exactly the same uniformity of structure (except for provincial tax rates) as currently exists.

This proposal is, in effect, a half-way house between the current system and a separate PIT. Under a 'tax on base', the provinces would not gain the freedom to set their own income definitions or allowable deductions. They would still be required to accept the consequences (in terms of revenue changes) of any federal changes in the structure of the system. This is so because any changes, except rate changes, that formerly affected 'basic federal tax' would still affect 'federal taxable income' (against which provinces would apply their rate and bracket structures).

In general, then, the following observations are appropriate. A common base and common structure (i.e., the 'tax on tax' approach) maximize harmonization and minimize compliance costs, but at the same time increase the need for federal-provincial consultation and cooperation on matters relating to the overall structure if the system is to be acceptable to all parties. A tax on base or income which maintains a common base but allows different provincial rate and bracket structures still requires some federal-provincial cooperation with respect to the common base, while eroding tax harmony only slightly and again only slightly increasing compliance cost. A fully independent PIT, with a separate tax collection facility, would minimize the need for federal-provincial consultation, would maximize compliance costs and administration costs, and would maximize the potential for both federal-provincial and interprovincial conflict (i.e., it would maximize the potential for eroding tax harmony).

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[1] Allan J. MacEachen, Federal Provincial Fiscal Arrangements in the Eighties, A Submission to the Parliamentary Task Force on Federal-Provincial Arrangements (Ottawa: Department of Finance, 1981), 55. Emphasis added.

Part IV: Council summary observations

—A separate PIT would give a province more freedom to determine both the overall distribution of income and the progressivity of the tax system.

—A province would have a greater ability to pursue horizontal equity goals under a separate PIT. For example, it would be possible to provide identical incentives to incorporated and unincorporated businesses. At present this is not possible.

—An alternative to the present 'tax on tax' system is the 'tax on base' or 'tax on income' approach. This would allow provinces to have their own rate and bracket structures but still ensure substantial tax harmony, since the underlying structure of the tax system would remain uniform. It seems to us that such an approach is consistent with the Tax Collection Agreements and yet goes some way toward allowing the provinces more freedom to tailor the PIT to their particular needs or desires.

PART V

An Integrated Tax-Transfer System

13

An Ontario PIT and socio-economic integration

The tax-transfer systems at both levels of government have frequently been described as patchwork systems dominated more by historical accident than by either administrative or economic efficiency. The purpose of this very brief chapter is to focus on the manner in which a separate PIT might provide the backbone for a highly coordinated system for delivering a comprehensive package of socio-economic programs to Ontarians. Programs in at least three separate areas could be coordinated through a separate Ontario PIT. The first area relates to the tax-transfer system in general and the tax treatment of the family in particular, the second to municipal funding, and the third to other taxation programs.

Social assistance and social insurance programs (such as family allowances, welfare, GAINS,[1] and the Family Benefits Program) could all be tied into a provincial PIT system. Chapter 15 of the background study, which deals with the tax-transfer treatment of the family, puts forward the concept of a 'credit income tax' as a potential integrating device. This system would offer a refundable personal income tax credit for each individual, few or no deductions, and a constant (or flat) marginal rate of tax. It would automatically provide a guaranteed income, since individuals with zero income, for example, would receive at least the amount of the refundable credit. Moreover, such a credit system would greatly simplify the treatment of families, since a refundable tax credit is effectively equivalent to a taxable family allowance and an exemption. Thus, it could replace the family allowance, the child exemption, and the existing refundable tax credit. It should be noted in passing that the provinces have the right to modify the present federal family allowance scheme but that only Quebec and to a limited extent Alberta have availed themselves of the opportunity. Obviously, a program like GAINS could also be integrated into this system. In addition, one would expect that it would be possible to build an incentive to work into the overall design.

A new system for delivering revenues to municipalities could also be grafted onto an Ontario PIT. Under this system, municipalities would be eligible to receive a certain fraction of the PIT receipts generated within their boundaries. Coupled with a meaningful municipal equalization scheme, this arrangement might help streamline the present system, which incorporates more than 80 different types of grants (an analysis of municipal PIT-sharing is given in Chapter 16 of the background study). The fact that Manitoba currently has such a program in place indicates that a separate PIT is not needed for its implementation, but this does not detract from the fact that it could be part of an integrated scheme.

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[1] Ontario's Guaranteed Annual Income System.

Finally, one might also utilize the PIT system to coordinate or integrate several other taxation programs. For example, in the Treasury background document which elaborates on the references given the Council, the Treasurer also addresses the possibility of replacing hospital and medicare premiums with a payroll tax. We offer no comment on the desirability of such a move (although it should be noted that this proposal was put forth in response to a possibility that Ottawa would outlaw such premiums), but it is clear that a separate PIT could provide the machinery for an effective collection mechanism. Much the same conclusion would apply to the integration of the personal and corporate income taxes, as discussed in Part II above. Moreover, a separate PIT would allow the implementation of a comprehensive tax credit scheme.

We hasten to add that we are not recommending such a proposal. However, our role is to focus on the potential costs and benefits of a separate PIT, and the possibility of utilizing an Ontario-run PIT as an integrating and coordinating mechanism for delivering the bulk of the province's socio-economic programs does represent a possible benefit, should the Government of Ontario be inclined to go in this direction. In passing, it should also be noted that such an overarching scheme might generate some scale economies at the administrative level and, hence, reduce the estimates of administrative costs that will appear in Chapter 15.

As is the case with most of the other potential benefits associated with an independent PIT, there are other avenues available for increasing the integration and efficiency of Ontario's socio-economic programs. Since Ontario has not exhausted these existing avenues, the Council does not assign much practical importance to this potential integrative role of a separate Ontario PIT.

Given the brevity of this part of the report, there is no need for a section on Council summary observations.

Part VI
Implications for Federalism

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An Ontario PIT and federal-provincial relations

INTRODUCTION

This chapter focusses on the implications for the Canadian federation of an Ontario-run PIT. It should come as no surprise that the range of issues underlying the interaction between a separate PIT and federal-provincial financial and economic relations are at the same time complex and controversial. For example, well-informed and well-intentioned people can come down on different sides of the centralization-decentralization issue. Moreover, the jargon associated with this general area is somewhat loaded. Terms such as 'province-building' conjure up for some a vision of a free-wheeling decentralized nation, whereas to others the notion of removing all impediments to the internal common market (sometimes referred to as 'nation-building' to contrast it with 'province-building') has overtones of converting the federation into a veritable unitary state. Thus it is with some trepidation and certainly with some delicacy that we venture into this general area. But we have little choice: the Treasurer's Reference explicitly requests us to consider the federal-provincial implications of a separate Ontario PIT. What is more important, these implications are critical to the overall analysis. No doubt some of the statements that follow can be viewed as favouring a more centralized federation and others a more decentralized federation. It goes without saying that our goal is to have analysis and evidence, rather than ideology, dominate the discussion.

Among the issues that will be addressed in this chapter are the following: the relationship between separate PITs and the preservation of the internal common market; the distinction between tax harmonization and fiscal harmonization; the problems of interprovincial harmonization under a regime of provincial PITs; and the strategic issues associated with going it alone on PIT.

AN ECONOMIC THEORY OF FEDERALISM

The traditional economic approach to federalism is based upon the premise that a decentralized form of government offers the possibility of increasing economic welfare by providing a range of locally (provincially) produced public goods and services that reflect the preferences of individuals within the community. Instead of requiring citizens to consume a uniform bundle of centrally provided public goods and services, sub-national governments provide alternative bundles of fiscal benefits, and citizens can choose their province or locality of residence ('voting by foot', as it were) on the basis of these various bundles. Hence, it is evident that not all harmonizing measures are either desirable or acceptable in a federation. Indeed, complete harmony of the fiscal bundles would emasculate federalism and convert the nation into a unitary state. This said, however, greater local autonomy may, of course, involve higher costs—for example, efficiency losses due to interprovincial differentials of various sorts. But this cost,[1], or at least part of it, might be better viewed as part of the price for our particular form of nationhood than as economic inefficiency.

It should be noted that we are making a distinction in what follows between harmony on the one hand and the absence of impediments to the internal economic union on the other. Lack of harmony need not imply barriers to the free flow of goods across provincial boundaries. For our purposes, such a barrier or impediment may be defined as a policy that *discriminates* on the basis of residence, although once again the line of demarcation is blurred.

Experience in other federations, such as the United States and Switzerland, suggests that Canada could tolerate greater diversity in provincial income taxes than exists at present. What is far from clear is whether the gains that might accrue from such diversity would exceed the costs. Among these costs would presumably be the need to develop a much more elaborate system of horizontal coordination of provincial taxes, as will be documented later in the chapter.

THE CONCEPT OF AN INTERNAL COMMON MARKET

Reference has been made in previous chapters to the concept of an internal common market or a Canadian economic union. It is now appropriate to discuss these concepts in more detail. Following Safarian,[2] one can develop a classification of the various degrees of economic integration:

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[1] It is also likely that a federal system will generate efficiency gains. Provincial experimentation with different forms of public goods and different delivery systems can lead to innovations that will be copied in other provinces, etc.

[2] A.E. Safarian, *Canadian Federation and Economic Integration* (Ottawa: Information Canada, 1974), Part I.

(a) *Free trade area*, which involves the removal of customs tariffs and of quantitative restrictions, such as quotas, on trade between the member countries, but with each member country retaining its own distinct barriers against non-members.

(b) *Customs union*, which, in addition to (a), standardizes such barriers by member countries against non-members.

(c) *Common market*, which, in addition to (b), removes restrictions on the movement of labour and capital between member countries.

(d) *Economic union*, which, in addition to (c), involves varying degrees of harmonization of national economic policies in order to remove discrimination that was due to disparities in these policies.

(e) *A Federal state*, the form of union in which the general government and the provinces or states each exercise exclusive jurisdiction in some major areas of policy and shared jurisdiction in others.

(f) *A Unitary state*, wherein the general government has jurisdiction over economic and other major policies.

In principle, the degree of economic integration should increase as one moves from a free trade area through to a unitary state. In practice, things can be, and are, different. For example, housing policy in Britain (a unitary state) is such that the impediments to labour mobility are far more severe than those in the Canadian federation. What is more important, in a federal nation one might expect that there will be an internal common market, i.e., a single national market in which goods, services, labour, and capital can move free and freely without impediments created by public authorities. Unfortunately, however, this is not always the case. For example, under the Treaty of Rome, which is the economic blueprint for the European Economic Community, there is closer collaboration and scrutiny with respect to eliminating protection-related industrial subsidies than there is within the Canadian federation. More generally, the list of barriers or impediments to the internal Canadian common market is virtually endless.[3]

The gains from internal economic integration are essentially the gains from specialization and trade. No region or province is equally efficient in the production of all goods and services. Achieving a high standard of living is thus dependent on a correspondingly high degree of specialization in the production of those goods in which the region or province has a comparative advantage and exchanging these for goods in which it has a comparative disadvantage.[4] It is important to recognize that Canada has access to a rather small domestic market, compared with some of her trading partners. To balkanize this domestic market would serve only to make it more difficult for industries to gain the efficiency benefits that come in part from market size. As far as individual Canadians are concerned, it is clear that their economic welfare, and that of the nation as well, is enhanced if they are free to locate wherever their skills can command the highest reward. Indeed, this is a right that ought to attend Canadian citizenship.

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[3] For a catalogue of these barriers, see Robert S. Prichard, Michael J. Trebilcock, Thomas J. Courchene, and John Whalley, eds., *Federalism and the Canadian Economic Union*, a volume sponsored jointly by the Ontario Economic Council and the Canada-U.S. Law Institute (Toronto: University of Toronto Press, forthcoming).

The existence of two levels of government, each with powers of their own, creates the distinct possibility that the internal economic union[5] will be fragmented by the actions of the governments. This can and does occur even though each government tends, in principal, to support the notion of an internal common market. Examples are not hard to come by: agricultural barriers (for commodities), residence requirements (for services), non-transferability of professional qualifications (for labour), and impediments such as the Quebec Stock Savings Plan and the recent B.C. tax credit (for capital). As noted earlier in this report, fragmentation of the domestic market is not due to the actions of provincial governments alone. Federal policy initiatives such as DREE, the regionally differentiated tax credit, and UIC benefits also serve to distort the geographical allocation of resources.

The Council has taken the position that it is in the interests of Canada and Canadians to preserve the Canadian economic union. And it is clearly in Ontario's interest, given the degree to which the province is dependent on both domestic and international trade. Nonetheless, we are aware that it is inherently very difficult to translate this desire to ensure the internal free flow of goods, services, labour, and capital into practical policy action, as the next section will highlight.

TAX VS. FISCAL INTEGRATION AND THE PRESERVATION OF THE CANADIAN ECONOMIC UNION

A violation of the internal common market can arise from *any* fiscal action (e.g., taxation, expenditure policies, regulatory measures) that favours a given activity (such as production, employment, consumption), on the basis of the province in which it occurs. Not all such discriminatory interventions necessarily lead to decreased economic efficiency. The analytic reason for this relates to what economists refer to as the 'theory of the second best'. In essence, it states that once *some*

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4 For more detail on the gains from an internal common market see Safarian, *op. cit.*, or Prichard *et al.*, *op. cit.*

5 For the purposes of this report, we are using the terms 'internal common market' and 'Canadian economic union' interchangeably, even though in a technical sense the latter involves more harmonization than the former.

imperfections or inefficiencies exist in the system, the introduction of additional barriers need not further reduce efficiency. This is a rather complex issue, but one that needs to be highlighted, albeit in as simplified a form as possible.

Consider the presence of provincial resource rents, which mean that some provinces have access to much greater revenues than do other provinces. In turn, this implies that residents of the resource-rich provinces have access to either greater public services at average provincial tax rates or the normal range of provincial services at much reduced tax rates. In either case, there is an incentive for people to move into these provinces. This is referred to as 'fiscal-induced' migration. Some individuals may even migrate to take up lower-paying jobs because the *overall* compensation package (including public sector net benefits) is higher in the resource-rich province. This is counter to national efficiency, although it is consistent with individual maximization.

Compensating fiscal action by the poorer provinces would reduce this inefficient migration. This is one of the principal theoretical rationales for the equalization program—to allow the poorer regions to provide comparable public services without resorting to unduly high tax rates. Equalization contributes to efficiency if it results in stemming the flow of migration that is motivated principally by fiscal, rather than by market, considerations. One problem with the current equalization program is that, for political reasons, it is unlikely that Ontario will ever be a recipient of equalization. Yet, in terms of the underlying economic arguments, there will be fiscal pressure on Ontarians to migrate west: thus, on efficiency grounds, Ontario is deserving of equalization. In the absence of equalization, interventionist fiscal policy (which would be viewed as an impediment to the free flow of goods and factors across provinces) might even contribute to efficient resource allocation. It is this sort of analytical issue that severely complicates the analysis of the relationship between the preservation of an internal common market on the one hand and the existence of a separate Ontario PIT on the other, and the manner in which they both relate to the issue of efficiency.[6]

Suppose, however, that we set this important issue to one side for the moment and accept the proposition that discriminatory action by a province that favours its own residents constitutes a barrier and is likely to lead, overall, to a reduction in output and efficiency. What can one then say about the relationship between the internal common market and an independent Ontario PIT? To this point in the report, most of the discussion of discriminatory measures and their effect on the common market has related to the possibility of their arising from the tax system. It is clear, however, that to focus only on the tax side is to sustain far too narrow a conception of the problem. Because expenditure policies, and particularly subsidy programs, are very close substitutes for tax measures, *the effects of a harmonized tax system may be effectively repealed by unharmonized expenditure and regulatory programs*. Thus, if the federal government is concerned about preserving the internal common market, it will have to cast its net much farther afield than its authority under the Tax Collection Agreements can go. This particular issue arose in Chapter 2 in connection with the analysis of tax credits. We cited several instances in which the federal authorities refused to administer particular tax credits because they constituted barriers to the interprovincial flow of capital and, therefore, violated the spirit of the Tax Collection Agreements. Yet on some occasions, Ottawa actually encouraged the provinces to implement the same measures as *expenditure* programs. This approach appears to place form over substance. What purpose are the Tax Collection Agreements serving in terms of preserving the internal common market if the federal government actually encourages provinces to fragment the internal market through expenditure programs? We grant that the costs (e.g., in terms of compliance and coordination) associated with barriers erected within the taxation system may be higher than the costs that arise when these barriers exist outside the tax system. Nonetheless, we believe that discriminatory or beggar-thy-neighbour actions on the part of the provinces should be decried whether such actions occur within the tax system or outside of it.[7] In short, the appropriate focus is not merely on taxation measures, but on *fiscal measures*.

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[6] For more detail relating to this general issue, consult Chapter 14 of the background study or F.R. Flatters and D.D. Purvis, 'Ontario Policies and the Problems of Adjustment in the 1980s', in *Developments Abroad and the Domestic Economy* (Toronto: Ontario Economic Council, 1981), 1, 129-65. A forthcoming Council-sponsored study will treat the issue in more detail still; see Thomas J. Courchene, *Equalization Payments: Past, Present, and Future*.

In this connection, it is interesting to note that during the series of federal-provincial meetings leading up to the new constitution, most provinces at one time or another expressed interest in a 'code of economic conduct' (which would be agreed upon *outside* the constitution) that would guide their policy actions in relation to preserving the internal economic union. The Council views this as a most beneficial initiative and encourages the Province of Ontario to continue to do all within its power to push for such an agreement. In making this recommendation, the Council is well aware that the federal government also plays a major role in fragmenting the Canadian economic union. Ideally, of course, it too would be a signatory of any code of economic conduct. Even in the absence of initial federal participation, a provincial set of ground rules or a guide to interprovincial fiscal action would, in our view, be desirable, particularly since it would put intense pressure on the federal government to follow suit.

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[7] This is subject to the proviso that the federal government tailor its intergovernmental redistribution policies to offset the inefficiencies arising out of differing provincial fiscal capacities.

In short, a 'code of good tax conduct', which is one interpretation of the Tax Collection Agreements, is not an adequate substitute for an overall provincial (and, more appropriate, federal-provincial) 'code of economic conduct', which would also cover the fiscal and regulatory activities of governments.

VERTICAL VS. HORIZONTAL TAX HARMONY IN A FEDERATION

When different levels of government resort to taxing the *same* tax base (as is the case with respect to the PIT and the corporate income tax), the need for *vertical* tax harmonization arises to keep in check the administrative costs of collecting taxes, the compliance costs for taxpayers, and the resource allocation costs of interprovincial differences. Obviously, this is a matter of even greater concern when provinces operate their own tax systems. For example, as Donald Huggett pointed out in an earlier Council-sponsored study of the tax system, 'the Province of Quebec was virtually forced to adopt the federal capital cost allowance system by pressure from business which found it too expensive to maintain two separate depreciation schedules or records.'[8]

The problem of coordinating the revenue systems of different governments at the same jurisdictional level is the concern of *horizontal* tax harmonization. In moving toward interprovincial tax systems that do not interfere with trade flows and resource allocation, the harmonization of tax bases is logically prior to the harmonization of tax *rates*. Unless there is substantial interprovincial uniformity among tax bases, *effective* rates of taxation will diverge even though nominal tax rates are the same. Since differences in effective tax rates are what matter for resource allocation, there is nothing to be gained by harmonizing tax rates unless the bases to which these rates apply are the same.

. Some considerable degree of harmonization is likely to emerge naturally. If a jurisdiction's tax rate is way out of line, it runs the risk of losing economic activity to other areas. Tax competition may thus restrain the emergence of tax differentials in a federation. In the area of corporate taxation, for example, both Ontario and Quebec have chosen to maintain general conformity with the federal definition of the corporate tax base that applies in other provinces, and all corporate systems accept a common formula for allocating profits of multi-province corporations across provinces. Indeed, it has been argued that tax competition, like price competition, is basically beneficial, in that it reduces the extent to which citizens

[8] Donald R. Huggett, 'Tax Base Harmonization', in *Intergovernmental Relations: Issues and Alternativies, 1977* (Toronto: Ontario Economic Council, 1977), 60.

can be exploited by their respective governments. From this vantage point, there need be no concern about harmonization—just let the system sort it out. While recognizing the valuable role that tax competition can play, the Council feels that there is some need for more formal harmonization processes, particularly for those taxes whose effects can easily be 'exported' to other jurisdictions.

Another source of harmonization, although it is not normally viewed in this light, is Canada's system of equalization payments. In theory, and to a considerable degree in practice, the role of equalization payments is to offset the highly unequal division of tax bases across the country and thereby to allow the more poorly endowed regions of the country to provide a satisfactory level of public services without resorting to unduly high tax rates.

Despite these tendencies toward harmony, the Canadian PIT falls short of complete harmonization, as revealed by the divergences in interprovincial tax rates in Table 3 of Chapter 1. Is this a serious problem? We do not think so. First of all, some tax differences will of necessity exist in a federal system. This is so even if it is the expenditure side that is used as the principal vehicle for delivering the varied bundles of provincial goods and services. Provinces desiring a larger overall provincial government sector will obviously carry a heavier tax burden, and in turn this necessarily implies lack of harmony in either tax rates or tax structures. Second, personal income taxes are levied on the *residence* concept. This means that irrespective of the province in which income is earned, a citizen is subject to taxation only in his province of residence as of the last day of the year. To be sure, this is only one of many conventions that could be enforced. And it does have some drawbacks for citizens who migrate in mid-year, only to find that their tax liabilities may have altered considerably. However, it simplifies tremendously the compliance and administrative costs associated with the PIT compared with a system where the province of *origin* for the income would be the taxing authority. In this situation, some individuals would be filing with several provinces each year. Thus, residence-based taxes minimize the degree to which the provinces can attempt to reach out and levy discriminating taxes against residents of other jurisdictions. On these grounds, many analysts have argued that personal income taxes are a far better vehicle for provincial taxation than source-based or origin-based taxes such as the corporate income tax.[9] Third, existing average and marginal PIT rates across the provinces can be misleading as a measure of levels of direct taxation. For example, Ontario has lower PIT rates than most provinces, but most do not have the system of medical and health premiums that Ontario does. Finally, by comparison with some other federations (e.g., the U.S.A. and Switzerland), the Canadian PIT system is a model of harmony.

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[9] See Chapter 14 of the background study for more analysis of this issue. With respect to administration/compliance and efficiency costs, Donald Huggett has suggested that if one had to choose between provincial occupation of corporate taxes or personal income taxes, one would opt for the latter: 'One [compromise] that appeals—if compromise is required—is that the provinces enact their own individual taxation statutes, but agree to a common base or system for the taxation of corporate income. Such a compromise would allow each province to deal with its residents on an individual basis according to perceived needs or policies, but would not create a 'tax jungle' which would be

Despite the fact that Canada might be able to tolerate more PIT diversity, harmonization and coordination problems will arise under a regime of provincial PITs.

TAX COORDINATION PROBLEMS UNDER MULTIPLE PROVINCIAL PITS

In principle, the tax coordination issue could be resolved in two ways. Interprovincial tax arrangements could be devised that would establish a situation in which Ontario investors[10] experienced no tax distortions with respect to decisions to invest outside the province rather than in it. Alternatively, a system could be devised that would not discriminate between non-resident investors and Ontario investors with respect to investment in Ontario. The former arrangement would promote *capital export neutrality*, whereas the latter would promote *capital import neutrality*.

Capital export neutrality prevails if, for Ontario residents, equal pre-tax returns on investments both in Ontario and outside the province provide equal after-tax returns. For example, under such a system, an Ontario resident would be indifferent between an investment yielding a 20 per cent pre-tax return elsewhere and one that yielded 20 per cent in Ontario, as the after-tax returns would be the same in both cases. This is consistent with the efficient allocation of the capital of Ontarians. On the other hand, capital import neutrality prevails if all investors, whether they are local or outside, pay the same rate of tax on investment in Ontario. In other words, capital originating elsewhere competes on equal terms in Ontario with Ontario capital. Capital import neutrality is thus consistent with the efficient allocation of capital within the capital-importing area.

The general rule in the industrialized world is that in principle foreign investment income is taxed at a rate which equals the domestic rate on investment that takes place at home, i.e., capital export neutrality. This is, of course, consistent with the *residence* principle, referred to above, that is part of the present joint PIT

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detrimental to the whole of Canada. Individuals, with a few exceptions, would only be subject to tax by the province in which they reside and by the federal government. Many corporations, on the other hand, carry on business in many provinces and there is therefore a more pressing case for them to be subject to a common regime.' *Ibid*., 62.

[10] The analysis focusses on investment income rather than labour income, because it is with the former that the principal difficulties lie.

arrangements. Given a system of separate PITs in Canada, the presumption is that this system ought to be continued. But it is not impossible to imagine some provinces attempting to exercise and retain first claim on income originating in their jurisdictions but accruing to non-residents (including residents of other provinces). Moreover, unless elaborate compliance costs were forced upon business reporting, it would be the treasury of the province where the income arose, and not the investor's province of residence, that received the tax stubs indicating the amount of income earned. This could complicate verification of tax returns considerably, since, in the absence of the joint federal-provincial return, much more emphasis would have to be placed on the taxpayers' integrity. One alternative might be to have a withholding tax in the province of origin and a system of tax credits in the province of residence. This would convert the system into a version of export neutrality. However, it would impose substantial compliance costs on persons with investment income but with no taxes owing when they attempted to recover taxes from other provincial governments. This is but one example of the complexities that could arise under a system of independent provincial PITs.

We believe that Ontario's interest in maintaining the free flow of goods and services across provincial boundaries is such that the province would move very quickly to ensure that interprovincial coordinating mechanisms establishing an adequate degree of horizontal tax harmonization were put in place. Nonetheless, the administration and compliance costs of achieving this harmony might be significant. At its worst, the whole process could unravel into an interjurisdictional rivalry, resulting in fragmentation of the internal common market and efficiency losses.

STRATEGIC ASPECTS AND PROVINCIAL PITS

Yet another issue associated with federal-provincial and interprovincial relations is what we have labelled the 'strategic' aspects of a separate PIT. For the purposes of this report, we define strategy as the range of 'action-response' options available within the context of multiple PITs. Up to this point, most of our discussion of the strategic aspects of an independent PIT has related to the possibility of Ontario's not paralleling federal structural changes. If Ontario had its own PIT and, therefore, could refuse to incorporate federal changes, the federal government might proceed more cautiously and perhaps even follow the consultation route prior to introducing tax changes.

However, this is a rather narrow perspective from which to view the likely range of strategic elements that would arise from a separate PIT. More generally, if Ontario were to adopt unique PIT provisions, other jurisdictions might react in any one of three ways. The provisions might simply be ignored. They might be emulated. Or they might be perceived as attempts at 'province building' at the expense of residents of other jurisdictions. In this third case, the other jurisdictions would likely try to mirror the Ontario provisions or else undertake retaliatory measures. It is undoubtedly the case that these questions, while intriguing, are basically intractable. Nonetheless, some elaboration is in order.

At one extreme would be those measures enacted by Ontario that, because of their potential for enhancing equity and/or efficiency, would eventually be incorporated throughout the PIT system. Earlier we referred to this as the 'demonstration effect' and used as a possible example the tax treatment of the inflation component of investment income. Although the federal level has now taken the initiative with respect to inflation-related tax reforms, the example is a good one in terms of the sort of innovations that could be made at the provincial level and, by virtue of their demonstrated effectiveness, become part of the overall PIT system. No doubt similar examples exist. This does represent one way in which a separate PIT could be of benefit not only to Ontario but to the country as a whole.

At the other extreme, suppose Ontario were to implement PIT features that had the effect of either encouraging Ontarians to invest funds in their own province or encouraging other provincial residents to invest in Ontario. It seems fairly clear that these or other such PIT provisions would be regarded as a source of significant negative impacts on the residents of other provinces, and that they would sooner or later provoke retaliatory measures that would offset, or more than offset, any initial benefit that Ontario might gain from them. 'Zero-sum games' often degenerate into 'negative-sum games'.

Moreover, were Ontario to adopt its own PIT, it is likely that some of the other provinces would also adopt their own PITs in order to react to the Ontario initiative. Indeed, the reverse is also true. Were Alberta and British Columbia to adopt their own PITs, Ontario might feel it necessary to follow suit. Were such a situation to develop (i.e., where several provinces had their own personal tax systems), the strategic aspects would probably alter dramatically, particularly *vis-à-vis* the federal structure. Ottawa would be left with its own structure plus a provincial component that would encompass only a small part of overall provincial PIT revenues. Considerations relating to the overall harmony of the system would no longer loom large in federal decision-making relating to tax structure changes, since Ottawa would have little control over the PIT structure.

The Council believes that it is in Ontario's interest to preserve the Canadian economic union. Hence, we do not place a high probability on the likelihood that Ontario would adopt beggar-thy-neighbour policies. Nonetheless, it does seem appropriate to point out that there could be very significant costs associated with such a move. This is particularly the case since certain provinces have access to much larger treasure chests to finance such activities than does Ontario. And as far as the federal government is concerned, there is literally no end to the instruments in its arsenal, should it desire to offset or retaliate against Ontario initiatives.

Given, therefore, that there could be substantial interprovincial fallout from a system of separate PITs, is it not possible that there exist alternatives to the current set of PIT arrangements which might obviate any need for this drastic move? The final section of the chapter is devoted to this issue.

MEASURES TO PRESERVE INTERPROVINCIAL PIT HARMONY

It is possible that the concerns expressed by Ontario and other provinces over the current PIT arrangements arise principally out of a sense of indignation and frustration stemming from the November 1981 federal budget and similarly controversial federal initiatives. Under this scenario, were Ottawa to pay a bit more attention to the provinces' concerns, the situation would again become satisfactory from the provincial standpoint. Such a situation is possible, but we do not deem it to be likely.

It seems to us that if some semblance of the present degree of tax harmony is to be preserved, the federal government has to recognize that it has basically two options open to it. First, if it wants to keep a rather tight rein on the expansion of tax credits, it will probably have to entertain the notion of a joint federal-provincial committee or commission on the common PIT structure (i.e., on the structure that goes into the determination of basic federal tax). This would require a significant change in attitude on the part of the federal government. It is not an overstatement to suggest that heretofore Ottawa has viewed the basic tax structure as fully within its exclusive jurisdiction. One does not have to agree with the view of the background document that Ottawa has behaved 'preemptively and imperiously' toward the provinces with respect to tax questions. But it is a matter of record that the federal government has modified the underlying structure in ways that have caused major changes in provincial PIT revenue and that these changes have been made without any notice, let alone consultation. Even as this report was being completed, several proposals which would amount to a fundamental restructuring of the personal income tax (e.g., removal of child and spousal exemptions) were aired by members of the federal cabinet. In our correspondence with the provinces in relation to this report, the message that came through loud and clear was one of frustration, and at times even indignation, over Ottawa's approach to the shared tax structure.

While the concept of a federal-provincial tax structure committee would require a significant change in Ottawa's attitude, it is not an unreasonable modification if the federal government wants to preserve the present tax harmony. After all, under the constitution both the provinces and the federal government have the right to engage in direct taxation. In the case of an impasse in this consultation process, the federal government still has the freedom to alter its own portion of the tax system by a series of appropriate measures *after* the calculation of basic federal tax, as was pointed out in the chapter on stabilization policy. The critical issue is simply that if Ottawa wishes to alter the *provincial* share of the tax system, the requirement for formal consultation does not appear unreasonable. To be sure, there are issues relating to budget confidentiality that complicate all of this. The recent federal green paper on the budgeting process may open the door to allow for this sort of modification. Our role is limited to making the recommendation for such a federal-provincial commission or committee on the shared tax structure and to alerting the federal government to the consequences that might follow in the wake of its maintaining its present stance with respect to tax structure changes.

A second route that the federal government could follow would be to allow a rather broad extension of the tax credit system, probably including as well the right of the provinces to apply their own rate structures against the common base. All provincially non-discriminatory personal income tax credits would be allowed. What provinces would be prevented from doing is implementing regionally discriminatory tax credits. Under this regime, the federal government might be able to retain some discretionary power over the underlying tax structure, since the provinces would now have some freedom to offset undesirable federal changes. The mere description of this alternative points out the value of the previous solution, or, at the least, of some combination of the two which would serve to minimize the compliance costs of a considerable extension of the tax credit approach.

If the federal government remains intransigent on these issues, it is within the realm of possibility that it will oversee the undoing of the Tax Collection Agreements.

Part VI: Council summary observations

—A greater degree of provincial autonomy with respect to the PIT would be consistent with the economic conception of federalism, which is to allow provinces the flexibility they need in order to deliver different bundles of public goods and services to their citizens. On the basis of international comparisons, Canada could probably tolerate more diversity in its PIT system. To be set against this potential benefit are a series of unknown efficiency costs as well as a set of administration/compliance costs that would attend a system of provincial PITs.

—Given its manufacturing and financial base, it is in Ontario's interest to have an internal market that is free of barriers to the movement of goods, services, and factors of production. Moreover, given that the Canadian market is already very small by international standards, a balkanization along provincial lines would be very costly. The Council takes a dim view of moves by any level of government that would further segment our internal market. It appears that the federal government relies on the Tax Collection Agreements as one of its principal instruments for ensuring a free internal market. This reliance reflects too narrow a conception of the underlying problem, since the internal market can be, and is being, balkanized on the expenditure and regulation front by both levels of government. In short, instead of a 'code of good tax conduct', the country needs a more general 'code of economic conduct' or 'code of fiscal conduct'. Moreover, it is important that the federal government also recognize that its own activities can and do serve to fragment interprovincial mobility.

—It is unlikely the case that there would be any lasting benefits associated with Ontario's implementing measures that were perceived by other provinces as being 'Ontario first' measures. Indeed, the opposite is more likely. Retaliation would likely convert these 'zero-sum games' into 'negative-sum games'. The very move by Ontario to adopt its own PIT could trigger separate PITs in other provinces, or vice-versa if Alberta or British Columbia follow through with their suggestions that they are contemplating going it alone on the PIT front.

—The Council believes that the preferable route would be for the federal government to accommodate some of the provinces' concerns within the framework of the existing Tax Collection Agreements. One option would be for the federal government to accept a more comprehensive system of provincial tax credits, provided that the credits did not discriminate against residents of other provinces. A better approach, in our opinion, would be to strike a federal-provincial committee on the shared PIT structure. The two parties to this arrangement would have equal status, reflecting the fact that both levels of government have a constitutional right to engage in direct (i.e., PIT) taxation. The federal government, by the use of its own system of tax credits, could still implement policies that the provinces opposed, but they would not be binding on the provincial tax structure.

—It seems to us that the most likely way of precipitating a series of independent provincial PITs would be for the federal government to continue to demonstrate the insensitivity with respect to the provinces in tax matters that has characterized its attitude over the last few years.

PART VII

Administrative And Compliance Costs Of An Ontario PIT

15
Administrative costs

INTRODUCTION

We now turn our attention to providing some estimates of the costs associated with running a tax collection system. The present chapter focusses on administrative costs. Chapter 16 deals with compliance costs. At the outset, it is important to recognize that estimating these costs is an inherently difficult exercise. Accordingly, for the administrative component, we shall report four sets of figures. The first is based on evidence provided to us by the federal authorities. The second draws on cost figures supplied by the Ontario Treasury. A third set of estimates derives from the experience of the Province of Quebec. Finally, the Council presents its best estimates. Perhaps 'guestimates' is the better word, since it is important to recognize that these numbers are not carved in stone, as it were.

Before we engage in the estimation exercise, it is instructive to focus on a more intangible but nonetheless important aspect of the cost of running a separate Ontario PIT.

VOLUNTARY COMPLIANCE AND THE PIT

One of the characteristics of the personal income tax is that its use as a source of government revenue depends critically on the level of compliance of those being taxed. In other words, it is basically a *self-assessment* system. The system is already very complex. Moreover, there is growing evidence that the degree of voluntary compliance is eroding. A very substantial literature has developed recently relating to the emergence of the so-called 'underground economy', a principal motivation for this being tax avoidance or tax evasion. It is within the realm of possibility that one of the costs of a separate Ontario PIT would be to further erode this existing citizen willingness to comply voluntarily with the system of direct taxation in this country. Were this to occur, the costs of raising the existing level of revenues would rise appreciably, since many more people would have to be employed to perform such functions as enforcement and audit. In what follows, we do *not* assume that this valuable asset of voluntary compliance would be eroded. To this extent the estimate of the costs, both administrative and compliance, may underestimate the true costs.

ESTIMATES BASED ON FEDERAL FIGURES

Personnel costs of an Ontario PIT

Table 11 presents a threefold classification of the personnel needs for an income tax system— mandatory programs, enforcement, and overhead. As noted in the table, these figures are based on federal estimates of the manpower needed to run a separate PIT. Thus, associated with each of the components in the table is an estimate of the federal personnel requirements for handling Ontario taxpayers. The final column presents estimates of the potential personnel needs for mounting a separate Ontario PIT. More detail relating to what is involved in each of these tasks, as well as to the manner in which the Ontario estimates were made, is available in Chapter 4 of the background document. An example might be instructive. With respect to item 2, public enquiries, it seems safe to assume that there would be less need at the provincial level to explain features of a system which were mainly patterned after the federal system. (However, experience in Quebec indicates that taxpayers will ask both provincial and federal officers the same questions, presumably to see if the answers are similar.) Thus, the Ontario estimates were put at 50 person years less than the federal ones. And so on. Overall, the numbers indicate that a separate Ontario PIT would require 4,000 person years, some 15 per cent or so less than the number of federal officials who currently handle Ontario tax returns.

Overall costs of an Ontario system

Table 12 presents estimates, based on the federal experience, of the over-all administrative costs of an Ontario PIT. The personnel cost (4,000 persons, from Table 11, at $22,000 per person) amounts to $88 million and the total costs come to $120 million. This does not include the cost of setting up a data centre, which, on the basis of federal experience, would have a capital cost of approximately $60 million.

This, then, is one estimate of the administration costs of a separate PIT—$120 million annually, plus a once-and-for-all capital cost of $60 million.

TABLE 11

Person years required to administer a personal income tax in Ontario: based on federal estimates

	Estimate of federal requirement for potential Ontario taxpayers[a]	Estimate of Ontario requirement
Mandatory programs		
1. Forms design & distribution	150 – 175	125 – 150
2. Public enquiries	325 – 350	275 – 300
3. Operating procedures[b]	175 – 200	150 – 175
4. File maintenance	425 – 450	400 – 425
5. Employer remittances	350 – 375	325 – 350
6. Revenue accounting & control	300 – 325	300 – 325
7. Initial processing of returns	725 – 750	700 – 725
8. Taxpayer-initiated reassessment	225 – 250	200 – 225
9. Appeals	175 – 200	100 – 125
	2,850 – 3,075	2,575 – 2,800
Enforcement programs		
10. Collections	325 – 350	300 – 325
11. Enforcement of filing	150 – 175	75 – 100[c]
12. Tax collector-initiated reassessments	225 – 250	100 – 125[c]
13. Audit	650 – 675	350 – 375[c]
	1,350 – 1,450	825 – 925
Overhead		
14. Central policies, procedures, personnel, and administration	400 – 425	375 – 400
Total	4,600 – 4,950	3,775 – 4,125

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[a] Based on estimates supplied by officials of Revenue Canada Taxation.

[b] For programming and operation of computer facilities, and for production of manuals for all procedures required in dealing with personal returns.

[c] Assuming a reciprocal exchange of information between federal and Ontario tax authorities.

SOURCE: Chapter 4, background study.

TABLE 12
Overall cost of an Ontario PIT: based on federal experience

Personnel	– 4,000 person years @, say, $22,000 each	$88,000,000
Space for personnel[a] at various locations	– say 1,500 employees @ 100 square feet each @ $15 per square foot	2,000,000
Computer costs	– say	5,000,000
Forms		13,000,000
Transportation and other costs		12,000,000
		$120,000,000

[a] The balance of the 4,000 personnel would be located in, say, a data centre. Based on federal experience, such a data centre would have a capital cost in the order of $60,000,000.
SOURCE: Chapter 4, background study.

ONTARIO TREASURY ESTIMATES

The Ontario Treasury officials provided the Council with three different estimates for the possible costs of mounting a separate PIT. They range, for annual operating costs, from a low of $56.1 million to a high of $116.3 million. The once-and-for-all set-up costs are estimated to be in the range of $29-34 million for all three estimates.

The Treasury's high estimate derives from figures supplied by Revenue Canada Taxation. Consequently, it corresponds quite closely to the federal estimate of $120 million given in the previous section.

The second estimate is based on the fact that the unit cost of collecting every $100 by Revenue Canada is $1.22. Applying this unit cost to Ontario's share of PIT revenues generates an annual operating cost of $56.1 million.

The final Treasury estimate uses the same methodology as the second approach, except that the unit cost relates to the Quebec experience, i.e., $1.61 for every $100 of revenue collected. Applied to Ontario, this generates an estimated annual cost of $70.5 million.

More detail relating to these Ontario Treasury estimates is available in Appendix 4A of the background study.

COUNCIL ESTIMATES BASED ON THE QUEBEC EXPERIENCE

As part of its background research pertaining to the administration costs of a separate Ontario PIT, the Council attempted some more-direct estimates based on the costs of the Quebec system. The Quebec revenue department has three main operations — corporate and personal income taxes and succession duties; sales and excise taxes; and rights and permits. The overall costs incurred by the Quebec revenue department for 1980-81 amounted to roughly $100 million. We assumed that two-thirds of the department's total costs relate to income taxes and succession duties and that, of the two-thirds, 70 per cent relates to the personal income tax system. This yields a personnel cost for the PIT of $57 million. Conversion to the Ontario situation, which has more than half again the number of files, generates estimates of $70 million and $85 million annually for personnel-related and total costs respectively.

THE COUNCIL'S ESTIMATES

Faced with this rather wide range of estimates for administrative costs, the Council background study concluded that:

1. $75-100 million (in 1982 dollars) was the likely range for the annual administrative cost of an Ontario PIT, and
2. the start-up costs and capital investments in buildings and equipment would be in the $60 million range.

As should be obvious from the above discussion, considerable uncertainty attaches to these estimates.

OTHER COSTS AND/OR SAVINGS

Under the present tax collection agreements, the federal government pays the provinces as the taxes become receivable. Ottawa bears the costs of bad debts. Currently, Ontario's share of taxes outstanding for more than two years is on the order of $35 million and of taxes overdue for less than two years is roughly $42 million. This represents an incentive for Ontario to continue with the existing arrangements. As an offset, a separate Ontario PIT would pick up the interest penalties of these overdue accounts. At present they go to the federal government. Estimates of these are unavailable.

Separate PITs would also give provinces, particularly growing ones, some opportunity to generate interest income from PIT revenues. This opportunity is lacking at present because of the manner in which the federal government transfers income tax revenues to the provinces. Hugh Curtis, Minister of Finance for the Province of British Columbia, made the point rather succinctly:

> British Columbia is not satisfied that the present method used by the federal government to estimate provincial tax entitlements for purposes of interim payments is fair and equitable.

> Interim payments during a year to those provinces which experience faster than average growth rates in personal and corporate incomes are usually less than their actual entitlements for the year. The balance of the entitlement is not paid until fifteen to eighteen months later, after actual collections for the taxation year are compiled. For British Columbia the balancing payments amounted to $125 million for the most recent year, 1979, and these payments were not made until January and March 1981. The loss of interest income to the Province through this delay in payment amounted to about $22 million.[1]

Just how important this problem is to Ontario is uncertain. However, during the period of high growth in the early seventies interest income forgone because of the interim payment arrangements may have amounted to a significant revenue loss.

There also appears to be a general concern that the federal government assigns a low priority to audit requests originating from the provinces. The current tax collection argeements allow the provinces to request that Revenue Canada carry out an audit, but there is no provision requiring Revenue Canada to comply with the request.

Finally, it might be possible to obtain some economies of scale in personnel if the Ontario PIT were part of an overall tax transfer system, such as that described in Chapter 13 above.

FEDERAL ADMINISTRATIVE SAVINGS ARISING FROM AN ONTARIO PIT

We have provided some rough estimates of the administrative costs of an independent Ontario PIT. How much of these are *net* costs? In other words, what would be the cost reduction to the federal PIT if Ontario established its own system, complete with a collection agency? The answer, perhaps surprisingly, is that there would be very little saving. This is rather evident from the response of the Deputy Minister (Revenue Canada Taxation) when questioned on the possible administrative savings at the federal level:

> The saving in the actual processing of returns would be quite small, and all the saving would relate to the provincial tax credits. . . .
>
> The tax collection agreements require us to do an audit of a small sample (two per cent) of all claims for the tax credits to measure compliance. The audit consists of requests to the sampled claimants to supply receipts showing rents or municipal property tax claimed. The elimination of these audits would also bring about a small reduction in our administrative costs. There could just possibly be some small reduction in inquiries from the public to our District Offices where the purpose of the inquiry relates solely to the provincial tax credits.

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[1] Honourable Hugh Curtis, 'Tax Harmonization and the Tax Collection Agreements', statement tabled at the meeting of Ministers of Finance and Provincial Treasurers, Halifax, November 23, 1981.

> There would be a small savings in paper costs, since it would not be necessary to include in the return package the schedule on which the taxpayer makes a claim for the provincial credits. It is, however, just one of a number of schedules required for a variety of purposes.[2]

Since the savings at the federal level would apparently be rather small, the administrative cost of an Ontario system would presumably be a *net* increase in the overall administrative cost of the personal income taxation system in Canada. There is one offset that should be included in this regard. Ontario currently pays the federal government for processing the Ontario tax credits. Under a separate PIT, the function would be taken over by the provincial authorities. The value of Ontario's tax credits for 1981 was roughly $240 million, for a cost of $2.4 million, assuming that *all* these credits were assessed at the maximum 1 per cent rate.

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[2] Letter to Douglas Hartle from Bruce MacDonald, Deputy Minister, Revenue Canada Taxation, July 21, 1982. Reprinted with permission.

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Compliance costs

INTRODUCTION

In addition to the costs of administration, a separate Ontario PIT would generate compliance costs. These costs would fall to individuals, who would have to deal with the complications of a separate tax form for purposes of filing and tax planning, and to employers, who would be responsible for deducting the separate PIT at source for their employees. Such costs are very difficult to quantify, but they can be every bit as important as administration costs. In attempting to estimate the compliance costs of an Ontario PIT, we have made the following assumptions:

—Initially, Ontario will introduce a PIT system that closely resembles the federal system.

—With the passage of time, however, variations will be introduced into Ontario's PIT in order to meet evolving political, economic, and bureaucratic circumstances or objectives. As was suggested in Chapters 3 and 4, we think it likely that an Ontario PIT would eventually mirror Quebec's PIT or Ontario's corporate tax in terms of its range of divergences from the federal system.

In assessing the compliance costs, we shall focus on four areas:

1. The additional costs to individual taxpayers who gather together the necessary receipts or other documents in support of a tax return, study the requisite forms and accompanying information, and carry out the computations involved in completing their own returns.
2. The additional out-of-pocket costs to those who engage professionals to complete their returns. Included in both (1) and (2) are the additional costs of tax planning resulting from any divergences in tax treatment between the Ontario and federal systems.
3. The additional costs to businesses that provide their employees with professional tax advice as part of their employee benefit packages.

4. The additional costs to businesses of modifying their payroll systems in order to withhold PIT deductions at source.

Excluded from the calculations in this chapter are the costs associated with lobbying Queen's Park by special interest groups seeking favours or incentives that can be delivered through a provincial PIT. These will be treated in a later chapter dealing with the political costs of an Ontario PIT.

COMPLIANCE COSTS TO INDIVIDUALS

As noted above, it is difficult to estimate the costs associated with the preparation of a separate provincial return. This is particularly true with respect to those individuals who do not seek professional help. It might be noted that an Ontario resident filling out his return for tax year 1981 faced sixteen pages of instructions, eight pages of tax tables, a four page form, and ten schedules. The Ontario tax credits were contained on a single page. In Quebec, the taxpayer received the same set of forms (without the Ontario tax credit page) *plus* a similar package from the province—a thirty page guide, a four page form, thirteen schedules, and a separate page for a real estate tax refund. This degree of divergence would not appear initially in Ontario, but we believe it to be a likely result as time passes.

Data obtained from a national accounting firm provided the breakdown of fees for preparing Quebec income taxes shown in Table 13. On the basis of these data, we assume that the marginal cost of a separate provincial return could be in the order of 25 per cent of the total cost of preparing the federal and provincial return. It should be noted that on the basis of information derived from federal income tax data some 30-40 per cent of all tax returns are professionally prepared, but of course not all of these returns would have fees associated with them that fall within the ranges depicted in Table 13.

The costs of compliance also include the effort and/or fees associated with responding to questions on provincial tax returns, with disputing provincial tax assessments, and with tax planning (e.g., for retirement) as a result of the differing tax provisions of the provincial and federal systems.

EMPLOYER COMPLIANCE

Employer compliance costs include the costs of establishing payroll deduction procedures, managing the cash flow, filing information returns, adapting the payroll system to any budget changes, extending personal financial advice relating to the provincial PIT to employees, etc. On the basis of information received from two large Ontario-based companies that have operations across Canada, it appears that the annual marginal costs of employer compliance in Quebec can average

TABLE 13

Fees for preparing personal income tax returns in Quebec

Type of return	Number of clients	Range of fee	Estimated fee for Quebec return
Federal and Quebec	600	$400–1,500	25–30% of fees
Federal, Quebec, and U.S.	35	$1,000–2,000	15–20% of fees

SOURCE: Chapter 5, background study.

about $10 to $20 per employee. The start-up costs for a separate PIT would be about the same as the annual cost.

OVERALL COMPLIANCE COSTS—AN ESTIMATE

Pulling these numbers together, the Council estimates, admittedly on a rather crude basis, that the marginal increase in compliance cost would fall in the following range:

	$ million
for individuals	75 - 225
for employers	30 - 60
total	105 - 285

There would also be the once-and-for-all start-up cost to employers, estimated to be in the $30-60 million range.

In other words, the compliance costs are likely to be as important as the administrative costs. Indeed, as our background document indicates, studies of compliance costs in various countries come to broadly similar conclusions: compliance costs tend to be higher than direct administrative costs and also to be distributed very unevenly among taxpayers.

As was the case for the administrative costs, these figures represent a *net* increase in the costs of complying with the overall PIT system.

A FURTHER WORD ON COMPLIANCE

It is important to distinguish between compliance costs and the degree to which taxpayers are willing to comply. For example, consider the corporate income tax system in Ontario before and after the Treasurer's 1982 Ontario budget. As a result of Ontario's decision not to parallel certain federal corporate tax changes, the costs of compliance have increased for Ontario corporations. However, the willingness of Ontario corporations to fill out the separate Ontario forms has presumably increased by leaps and bounds, since these corporations now stand to save a good deal in taxes arising from the operation of the separate Ontario system. More generally, the cost of compliance will always be present, but the degree of taxpayer willingness to go through the effort of filing separate returns will probably be closely linked to the perceived benefits received from the existence of a separate Ontario tax. Presumably this would carry over to an Ontario PIT as well.

As a final comment on the estimate of both administrative and compliance costs, the Council wishes to emphasize the 'guestimate' nature of the numbers reported in these two chapters.

Part VII: Council summary observations

—Considerable uncertainty exists with respect to the possible costs or benefits of a separate PIT in most areas, but this is not the case with respect to administrative and compliance costs. To be sure, there is uncertainty as to the precise amount of the costs, but not as to the existence of such costs.

—The administrative and compliance costs of a separate Ontario PIT would be sizeable. Estimated annual administrative costs are in the $75-$100 million range, with an initial capital investment of some $60 million. Estimated annual compliance costs fall in the $105-$285 million range, with an initial start-up cost to employers of $30 to $60 million.

—In general, these figures represent *net* increases in the administrative and compliance costs associated with the overall PIT, since they would not be substantially offset by savings at the federal level.

—The costs of both administration and compliance could be minimized somewhat if the provincial PIT maintained considerable harmony with the federal PIT.

PART VIII
Political Implications

17

Politicians, bureaucrats, lobbyists, and the PIT

INTRODUCTION

In this, the final substantive chapter dealing with the benefits and costs of an independent PIT, the focus is directed to political issues. Our use of the term 'political' relates not to partisan politics but rather to the manner in which an independent PIT would alter the relationship between the citizen and the province. For citizens, this change would involve an increased awareness of the role that the province plays in their economic lives and also a recognition of the increased range of opportunities made available by the possibility of dealing directly with Queen's Park. The politicians too would have new opportunities, e.g., an increased freedom to tailor policies to the needs, real or perceived, of voters.

SOME BENEFITS AND COSTS OF THE PRESENT SYSTEM

It is a fairly safe bet that the average taxpayer is not fully aware of the shared nature of the present personal income tax scheme. Cheques or money orders for taxes owing are made out to the federal government, not to Ontario. On the other hand, the role of Ontario is more visible when it comes to the system of provincial tax credits. To the extent that this is indeed the case the province has it both ways, as it were.

With respect to tax changes initiated at the federal level, the province can also play both sides. In the case of tax reforms that the province deems to be desirable but that are politically unpopular, it is typically the federal government that draws the wrath of taxpayers. In the case of changes that the province too does not like, it can join the parade of protest against the federal government. On the other side of the ledger, the province does in the end have to parallel the federal tax moves, even if it finds them inappropriate. Apart from the fact that there appears to be little role for prior consultation with respect to proposed federal tax changes, the province is at a further disadvantage: it does not have a PIT bureaucracy and hence is no match for Ottawa when it comes to hammering out the conceptual, administrative, and compliance aspects of structural changes in the system.

POLITICAL ADVANTAGES OF A SEPARATE PIT

Several advantages of a separate PIT readily come to mind:

—The province would have the ability to disassociate itself from unpopular and otherwise inappropriate federal PIT reforms.

—The politicians would have more ability to target tax changes to particular groups.

—The province might acquire increased bargaining power *vis-à-vis* the federal government. This could come about in several ways. First of all, as noted in the previous chapter, Ottawa might be interested in consultation prior to any federal tax changes in order to see if there were federal options which Ontario might parallel in its own tax legislation. Second, the province could now signal its intent to alter some aspect of the tax structure and this might lead to federal-provincial discussions on the issue in question. Finally, the presence of a qualified civil service relating to PIT matters should lead to a substantial increase in the communication links between Ontario and Ottawa.

—The large number of taxpayers who would receive tax refund cheques from Queen's Park would increase their identification with Ontario.

—More generally, there would be an increased awareness on the part of Ontarians of the role that the provincial government played in their lives. This might be channelled into an increased interest generally in provincial affairs.

POLITICAL COSTS OF A SEPARATE PIT

Among the costs, some of which are the mirror image of the benefits, are the following:

—A much greater tax visibility for the province. Taxpayers would now make out cheques directly to Queen's Park. Employers would have to withhold taxes on behalf of the province and prepare the Ontario equivalent of T4 slips, etc.

—The province would likely be bombarded by lobbies for special interest groups seeking every manner of concession and/or special treatment.

—Taxpayer uncertainty would likely increase as citizens recognized that there were now two levels of government with the power to directly affect their level of take-home pay.

—Other provinces' view of Ontario would probably be altered considerably. For example, it is likely that some of the smaller provinces, for whom a separate PIT is not a viable alternative, would tend to view Ontario as a source for potential balkanization of the federation.

This listing of some of the political costs and benefits is meant to be more illustrative than exhaustive. Readers are no doubt able to come up with other costs and/or benefits to add to the ones we have highlighted.

The summary manner in which this part of the report has proceeded obviates the need for any concluding observations.

PART IX
A Summing Up

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Alternatives to a separate Ontario PIT

INTRODUCTION

The role of this part of our report is to pull together the various threads of the analysis. Chapter 19 ('The Benefits and Costs of an Ontario PIT') is devoted to precisely this. But before we embark on that exercise, it will be useful to focus on the range of alternatives that lies between the *status quo* on the one hand and the move to a fully independent PIT on the other. This information is valuable in its own right. However, it is also of considerable importance to the analysis in the following chapter. This is so because in evaluating the potential benefits and costs it is important to recognize, for example, that some of the benefits of an independent PIT could be obtained with less drastic institutional changes. Likewise, some of the costs of a separate PIT could be ameliorated by appropriate coordinating mechanisms.

A MENU OF ALTERNATIVES

As one might guess, the spectrum of possibilities between the present system and an independent PIT is not conveniently subdivided into neat compartments. The options overlap considerably and it is often not obvious whether option A, for example, is closer to the *status quo* than is option B. Be that as it may, Table 14 provides an overview of several possible intermediate steps and a brief outline of the characteristics of each. The table is meant to be self-contained, but some elaboration is probably warranted.

The first option listed in the table is the move toward a joint federal-provincial committee on the shared tax base. A committee of this sort could either play a consultative role or, as indicated by Table 14, be an integral part of the system. Either arrangement might constrain the federal authorities, e.g., by interfering with budget secrecy or by limiting Ottawa's ability to make the tax changes it deemed appropriate. As far as the latter problem is concerned, Ottawa could still alter its own portion of the tax system through the appropriate use of tax credits. The table also suggests that one version of such a scheme might be that the

TABLE 14
Alternatives to a separate PIT

Alternatives	Characteristics	Elaboration
1. The *status quo*	– Centralized federal collection. – Minimizes administrative and compliance costs. – Provincial flexibility limited to applying single tax rate to basic federal tax and to implementing a restricted set of non-discriminatory tax credits. – Provinces required to accept all federal changes in underlying tax structure. – Consultation on such changes limited or non-existent. – Limited and temporary revenue guarantee.	– Provinces are expressing increased concern over lack of consultation with respect to major and sudden federal changes. – Provinces also appear to be constrained in implementing development tax credits. New B.C. tax credits may provide a precedent.
2. A federal-provincial committee on the structure of the shared tax base	– No changes in the current Tax Collection Agreements. – Provinces would have equal status on the committee, reflecting the joint occupancy of the tax field and the constitutional rights of both parties to engage in direct taxation.	– Could run into problems relating to federal budget secrecy in spite of recent initiatives to open up the process. – Would not prevent federal action, since there would be plenty of scope for Ottawa to enact changes *after* the calculation of basic federal tax (e.g., federal tax credits). After some period of notice (say three years) these federal changes would become part of the shared tax structure, even if there were no agreement on the part of the provinces. – A stronger version of this option would require joint federal-provincial agreement prior to all changes in the shared structure. Hence all controversial federal changes would have to be implemented 'below the line', as it were.

TABLE 14, continued

Alternatives	Characteristics	Elaboration
3. Tax on base	– Provinces would tax the federal base instead of piggy-backing on the federal tax. – Provinces would have control over their own rate and bracket structures. – Federal changes in tax rates would no longer affect provincial revenues. – Common structure for the base would still obtain. – A slight increase in compliance and administrative costs. – Would appear to fit easily within the Tax Collection Agreements.	– Federal government would still have the power to alter the base and thereby bind the provinces, since base changes would affect their revenues. – Federal government would lose some control over vertical equity in the tax system; but if the provinces utilized the currently allowable tax decreases and surcharges they could come close to duplicating a tax on base.
4. An extension of the tax credit system: I	– All regionally or provincially non-discriminatory tax credits would be allowed. For example, savings and investment credits that did not discriminate against assets in other provinces would be allowed. – Compliance and adminstrative costs would rise somewhat. – Provinces could offset some federal changes so that lack of consultation is less of a problem. – Current federal collection fee for provincial tax credits would continue to apply.	– Could be combined with a joint consultative process and/or a tax on base. – Would change the current structure more in terms of degree than of substance.

TABLE 14, continued

Alternatives	Characteristics	Elaboration
5. An extension of the tax credit system: II	- Items under 4 would continue to apply. - Provinces could opt for tax on base (i.e., their own rate and bracket structure). - Tax credits or surcharges applicable by type of income (e.g., business income, property income, employment income) would be allowed. - Compliance and administrative costs might rise substantially, but still much less than under a separate PIT. - No tax credits or surcharges that discriminate against other provinces would be allowed.	- Would require less federal-provincial coordination, since the provinces could in effect chart their course. Indeed, extending the tax credit system to this degree would give the provinces most of the flexibility they would gain from having their own PITs. Apart from their inability to impose regionally discriminatory tax credits, the provinces would also be unable to tax sources of income not included in the federal income tax base.
6. Separate provincial PITs	- No restrictions on provincial PIT flexibility. - Maximize compliance and administrative costs. - Minimize necessity for federal-provincial consultation on tax matters.	- Would require substantial horizontal (interprovincial) harmonization in order to minimize efficiency losses.

federal-provincial committee would only be able to delay proposed federal changes in the underlying structure, not to block them permanently. In short, there is a considerable range of possible roles for such a committee.

A second possible alternative is the 'tax on base' concept. This option has already been discussed in some detail in the chapter on income distribution. Essentially, such a modification would allow the provinces to set their own rate and bracket structures and apply them to 'taxable income', just as the federal government currently does. The tax base would remain common and, at one end of the spectrum, under federal control. At the other end, however, this tax-on-base option could be combined with some formal consultation process relating to the structure of the common base, as elaborated in Table 14 (alternative 3).

The two other options reported in Table 14 relate to possible extensions of the system of provincial tax credits. The first of these (alternative 4 in Table 14) is far more limited than the other, but it would give the provinces the right to instigate provincial savings and investment tax credits. This would not create a major structural change in the current arrangements. However, the second version of the tax-credit extension in the table would do so. It is included principally to outline the likely limit to which the current system could be pushed. There is no suggestion that it would be acceptable or even desirable. It would give the provinces the maximum degree of flexibility possible under a single federal collection agency—indeed, so much flexibility that there would not be much need for federal-provincial consultation, since the provinces could undo, for their own portion of the tax system, any federal changes that they viewed as undesirable.

The final entry in Table 14 is a separate provincial PIT, under which, of course, the provinces would have complete flexibility even to the extent of being able to introduce measures designed to fragment the internal economic union, although there is no presumption that the provinces would use their tax systems in this way.

There are no doubt still other options, or combinations of existing options, that could have been included in the table. The essential point is nonetheless clear: a separate PIT should not be seen as an all-or-nothing choice, since there is a range of intermediate alternatives. The existence of these intermediate stages allows one to sort out in a more precise way the costs and benefits of moving to a fully independent PIT. Moreover, they provide a convenient backdrop against which to assess the strengths and weaknesses of the current PIT arrangements.

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A compilation of the benefits and costs of a separate Ontario PIT

Table 15 provides an overview of some of the potential benefits of a separate PIT, and Table 16 summarizes the principal costs. In general, the entries in these tables follow the chapter outlines of the report. The final column of the benefit table focusses, where relevant, on the alternative arrangements short of an independent PIT that would deliver the same potential benefits. As for the costs associated with a separate PIT, the final column of Table 16 proposes alternatives that might reduce their severity.

The tables are designed to be self-contained; the task of drawing conclusions from them is left entirely to the reader.

Ideally, one would be able to assign dollar values to these various benefits and costs. Unfortunately, this is impossible to do, in part because the benefits or costs are often highly uncertain and in part because they are simply not commensurate. However, by applying a weighting system to the various benefits and costs, the reader should be able to come to an overall conclusion as to the wisdom of going the separate PIT route. For our part, we too shall now turn to some overall conclusions and recommendations.

TABLE 15
The potential benefits of a separate PIT

General subject area	Specific focus	Potential benefits of a separate PIT	Elaboration	Alternative avenues for achieving the same goals
Growth and efficiency	Labour supply	- Some possibility for influencing labour supply (e.g., secondary workers).	- Considerable analytic uncertainty as to effectiveness.	- Programs like day care, etc., are probably just as effective.
	Labour quality	- A separate PIT could influence skill levels via changes such as tax credits for tuition fees.		- Other provincial programs, such as the level of university funding and OSAP, probably have more impact.
	Migration	- PIT could be used to offset pressure to move to fiscally rich provinces.	- Relates to the fact that unequal fiscal capacities of provinces present an inducement to migration.	- Modifications in existing equalization program.
		- Could be used to influence location of certain types of individuals (e.g., professional and executive class).	- Would ensure that these mobile sectors faced overall taxes not much different from those in alternative locations (often these are in the U.S.)	- Could be accomplished via a system of tax credits if there were sufficient flexibility (i.e., category 5 of Table 14).
	Savings	- Could have significant influence on channels through which agents save.	- Not likely to increase overall investment unless capital markets were imperfect.	- System of tax credits for savings.
		- Might increase total savings.	- Considerable uncertainty here.	

TABLE 15, continued

General subject area	Specific focus	Potential benefits of a separate PIT	Elaboration	Alternative avenues for achieving the same goals
	Corporate investment	- Would give provinces much greater flexibility in treating corporate source income.	- Considerable uncertainty (would depend on capital market imperfections, characteristics of marginal investors, etc.)	- Much could be accomplished through corporate tax credits.
	Unincorporated business	- Could allow similar treatment (neutrality) of corporate and unincorporated enterprises.		- Difficult to achieve without a separate PIT.
	New enterprises	- Freedom to provide a range of tax credits or even follow Quebec's Stock Savings Plan.	- Capital markets likely imperfect here, so there is a possibility of significant impact.	- SBDCs appear to be reasonably successful.
	Inflation distortion	- One area where Ontario could have taken the lead to enact changes in overall PIT regime.	- Concern over Lortie Report indicates that PIT provisions could make a difference.	- More consultation between Ottawa and the provinces may lead to other such changes.
Stabilization policy	Sector specific policies	- A separate PIT would provide Ontario with an additional set of tax instruments with which to influence its economic well-being.	- However, in general, expenditure policies have a larger impact on aggregate demand than tax policies.	- An extension of the tax credit approach.
	Leverage	- Ontario would no longer be required to accept federal changes which were not in its interest.		- Leverage could be eliminated by having the federal government utilize its own set of tax credits when making changes undesired by the provinces.

TABLE 15, continued

General subject area	Specific focus	Potential benefits of a separate PIT	Elaboration	Alternative avenues for achieving the same goals
Income distribution	Rate and bracket structure	- Ontario would obtain freedom to determine its own rate and bracket structure.	- The tax side is only one determinant of overall income distribution. The present tax credit system (e.g., surcharges and tax reductions) also provides some flexibility.	- A move from the present 'tax on tax' system to a 'tax on base' system would also accomplish this.
	Exemptions, deductions	- Province would have complete freedom with respect to these issues.		- Probably requires a separate PIT.
Socio-economic integration		- A separate PIT would provide a framework for delivering an integrated package of socio-economic benefits to citizens (e.g., family allowance, GAINS, welfare, payroll taxes, municipal PIT sharing).	- Ontario has shown little desire to move in this direction.	- Much could be done along these lines under the present system.
Federal-provincial implications	Retaliation	- Separate PIT might be necessary if other provinces went the independent PIT route.	- This would be more in the nature of minimizing losses than of striving for gains.	- Emphasizes the importance of better federal-provincial relations on these tax issues.
		- Separate PIT might be necessary if the federal tax structure did not take sufficient account of the particular economic structure of Ontario.		- Same as above.
	Strategy	- Ontario would have more influence on the federal system.	- If there were a system of provincial PITs, harmonization might no longer be a federal objective.	- Increase in influence could also be accomplished through a federal-provincial committee on the tax structure.

TABLE 15, continued

General subject area	Specific focus	Potential benefits of a separate PIT	Elaboration	Alternative avenues for achieving the same goals
		– 'Demonstration Effects' – provincial experimentation with a PIT could lead to improvement in overall system.		– Same as above
Political aspects	Civil service	– Ontario would develop PIT expertise and in this way would have greater communication with federal government and perhaps more influence on the overall system.		– Again, the consultation route, formal or otherwise, is an alternative.
	Awareness	– Would lead to greater citizen awareness of Queen's Park as a factor in their daily lives.		
		– Politicians would have an additional set of instruments to deploy.		– An enlarged tax credit system or a tax on base would also enhance instruments.
Other		– The different structure of the Ontario economy compared to those of other provinces and the source of its economic competition (often the U.S.) imply that the federal tax system, which has to be national in scope, may from time to time be off base with respect to Ontario's needs.		– More formal consultation with the federal level over tax matters combined with some greater tax credit flexibility

TABLE 16
The potential costs of a separate PIT

General subject area	Potential costs of a separate PIT	Elaboration	Measures that might reduce the costs
Administrative costs	- The costs associated with personnel, enforcement, collection, etc., would be significant and unavoidable.	- Would constitute a net increase in overall PIT administrative costs, since offsetting federal savings are small.	- Integrating PIT administrative costs with other programs (e.g., corporate tax) to spread overhead.
Compliance costs	- These costs for both individuals and for corporations would also be significant and unavoidable.	- Would constitute a net increase in compliance costs for overall PIT.	- Maintaining similarity with federal PIT wherever possible.
Growth and efficiency	- To the extent that the measures under this category in Table 15 were successful, they would probably invite retaliation and could degenerate into negative-sum games.	- Note that the current system also has some discriminatory measures (Quebec's SSP and the new B.C. tax credit).	- Ensuring that PIT measures were non-discriminatory *vis-à-vis* other provinces.
Stabilization policy	- Might weaken the federal government's ability to stabilize the economy.	- Ottawa has many other avenues (expenditure programs, transfers, sales and excise taxes, corporate taxes, commercial policy and regulatory measures).	- More coordination with Ottawa over the stabilization role. - Ottawa could still make any changes it wanted to in its own portion of the PIT.
Income distribution	- Loss of federal dominance in establishing vertical equity in the tax system.	- Provinces already have the ability through tax surcharges and increases to modify progressivity.	
	- Federal government might feel even less reluctant than at present to modify its tax structure.	- This is a general comment and could fall under any of the subject areas.	- A federal-provincial consultation or coordinating committee on the PIT structure.

TABLE 16, continued

General subject area	Potential costs of a separate PIT	Elaboration	Measures that might reduce the costs
	– Wider variance in marginal rates across provinces.		– Marginal rates vary considerably under the present regime.
Socio-economic integration	– Province controls only one-third of overall PIT. Establishment of an elaborate delivery system around a provincial PIT could be made unworkable and/or outmoded by federal action with respect to its own PIT.	– This is also in the way of a general comment. All activities embarked on under a separate PIT would be subject to considerable uncertainty as to how Ottawa would respond with major alterations in its share of the PIT.	
Federal-provincial implications	– The PIT could be used to erect interprovincial impediments to the free flow of goods and factors.		– A federal-provincial code of economic and fiscal conduct.
	– Retaliatory measures by other provinces.	– Would erode most of the benefits and could generate overall efficiency losses.	– Same as above.
	– Retaliatory measures by Ottawa.	– Same as above.	– Same as above.
	– Increased compliance and administrative costs arising from the need to harmonize provincial PITs.		– An interprovincial tax harmonization agreement.
Political aspects	– Greater tax visibility.		
	– Increased presence of special interest groups.	– Would probably not be offset by much of a decrease in lobbying at the federal level.	– Commitment to preserve harmony wherever possible with the federal system.

TABLE 16. continued

General subject area	Potential costs of a separate PIT	Elaboration	Measures that might reduce the costs
Other	- Erosion of citizen willingness to comply with PIT.	- The tax system is already very complex. A separate PIT would make it more so.	- Maintain harmony wherever possible with the federal system.
	- Potential for increasing overall uncertainty in the system.	- Now two levels of government would be able to make PIT changes.	
	- A move to a separate PIT is likely to be irreversible.		

PART X
Conclusions And Recommendations

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Conclusions

In the previous chapters we delved into the history of the personal income tax in Canada, with particular emphasis on the twenty-year experience with the current Tax Collection Agreements. We looked in considerable detail at the evolution of provincial tax credits from their inception in 1972 right through to the recent and perhaps precedent-setting B.C. Housing and Employment Bond Tax Credit. Attention was directed to Quebec's experience with its own PIT and Ontario's experience with operating its own corporate income tax. Then we focussed on a series of economic issues—growth and efficiency, income distribution, stabilization policy, and socio-economic integration. We have also dealt in some detail with the administrative and compliance costs that would be associated with a separate PIT. Finally, we assessed the federal-provincial and political implications of a separate PIT. In Part IX of this report, we pulled together some of the costs and benefits and also presented a range of intermediate alternatives that might exist between the current Tax Collection Agreements on the one hand and a separate Ontario PIT (or a system of separate provincial PITs) on the other.

As we interpret the Reference, the Council has not been asked for a 'Yes' or 'No' on the issue of a separate PIT. Rather, we have been instructed to investigate and report on the following question:

> What would be the economic implications if the Province of Ontario were to withdraw from the present Tax Collection Agreement with the federal government and institute its own personal income tax collection system?

We believe that the previous chapters represent a detailed answer to this question. Properly speaking, no overall concluding comments are required. However, because the issues at stake are so important for the province and the country, the Council has taken upon itself the responsibility to draw some conclusions and to offer some recommendations.

Our first conclusion is that the Tax Collection Agreements have, in general, served the nation very well. They have given the country not only a decentralized PIT system in which the provinces do have some freedom to tailor their portion of personal income taxes to the needs of their citizens but, as well, a very harmonized system in comparison with the tax systems of other federal states (e.g., the United States and Switzerland). To be sure, there are, in true Canadian fashion, some compromises involved in the operation of the joint federal-provincial PIT system. The provinces have their taxes collected free of charge by the federal government. In return, they are required to adhere to a common tax base structure.

In 1972, with the federal government involved in personal income tax reforms and the provinces desiring some additional flexibility of their own, the Tax Collection Agreements were modified to allow for the implementation of provincial tax credits. In addition, a generous revenue guarantee was instituted in order to isolate provincial revenues from the effects of federal changes in the shared tax base. Thus, the Tax Collection Agreements proved to be sufficiently flexible to accommodate the needs of both the federal government and the provinces.

Ten years later, the Tax Collection Agreements are undergoing further strain. Neither of the parties is without blame for this situation, which may very well have more to do with the recent deterioration in federal-provincial relations than with the specific taxation matters under debate. Nonetheless, there are important PIT concerns at issue. The provinces, or many of them, are quite frustrated with the approach that the federal government has taken to the common tax structure. In effect, it has seen itself as having the right to alter the shared tax structure, unilaterally and without so much as prior provincial consultation. This manner of proceeding presents the provinces with what amounts to an ultimatum: absorb the federal government's structural changes into their own tax systems or withdraw from the Tax Collection Agreements. Not surprisingly, the provinces have taken a dim view of this process. And with good reason, since the PIT is, in fact, a shared tax and the provinces have a constitutional right to engage in direct taxation.

But the provinces also have to accept a share of the blame. Spurred on, perhaps, by Quebec's Stock Savings Plan, the provinces have been bombarding Ottawa with proposals for 'development' tax credits that would in many cases have the effect of fragmenting the internal economic union. It may well be that these proposals merely reflect the tendency of governments around the world to turn toward protection when the economy falls on hard times. Whatever the reason, the Council views these balkanizing tendencies as unacceptable, whether they occur within the PIT structure or in the form of regulatory or expenditure programs.

Must the end result of this conflict be a system of separate provincial PITs? Or can the Tax Collection Agreements once again be modified to accommodate the needs of both the federal and provincial levels? We do not claim to know the answer. But there are some possible modifications of the existing arrangements that might provide an acceptable compromise. To these we now turn.

PROPOSALS FOR MODIFYING THE CURRENT SYSTEM

Since the pressures on the system are twofold—the provinces' desire for increased flexibility and the federal government's concern with the provinces' action in mounting barriers to interprovincial trade—so much be the proposals.

It seems to us that the federal government has to become more accommodating in one of two ways. If it wants to continue to call the shots on the shared tax structure, it is going to have to be more flexible in terms of the number and types of tax credits that the provinces can implement (but still excluding those that are designed to be 'province-first' credits). If it wants to restrain the growth of provincial credits, it is going to have to allow more provincial input into the determination of the shared tax structure. We shall deal with the second of these alternatives first.

A federal-provincial committee on the PIT structure

The Council has come to the view that it is desirable to set in place a federal-provincial tax structure committee. The particular form that such a committee would take is not as important as the fact that one should exist. At one extreme, it could be patterned after the various intergovernmental relations committees or secretariats that exist in other federations, e.g., the Advisory Council for Intergovernment Relations in Australia or the Advisory Commission on Intergovernmental Relations in the United States.[1] It might be noted in passing that Canada must be one of the few federations (perhaps the only one) without such an intergovernmental committee. At the other extreme is our own Tax Structure Committee of the mid-1960s, composed of the ministers of finance and a secretariat, which at its peak consisted of three professionals, three typists, and a clerk.[2] Its mandate was 'to carry out background studies and prepare proposals for the future financial structure of the Canadian Federation.'[3] To be sure, this was a rather broad mandate, but in the view of one observer, it produced 'one of the most comprehensive financial reviews and forecasts in Canada's history',[4] and has as one of its achievements the development of the comprehensive equalization scheme that, with some variation, is still in place today.

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[1] For a description of these advisory committees, see A. John Robinson, 'An Intergovernmental Commission for Economic Policy', in Richard Bird, ed., *Fiscal Dimensions of Canadian Federalism* (Toronto: Canadian Tax Foundation, 1980), 55-82.

[2] Robert McLarty, 'Organizing for a Federal-Provincial Fiscal Policy', *Canadian Tax Journal*, 15 (July-August, 1967), 412.

Since we do not have any expertise in the area of organizational design, we leave this important exercise to the parties involved. Whatever the commission's form, in terms of precise functions it could take on a variety of roles. At one extreme, it might only be a consultative body, while at the other extreme its decisions with respect to the shared tax structure would be binding. Between these extremes, one can visualize a system which, if there were disagreement, would allow the provinces, say, a three-year period before any federal changes became binding on their own structures. In the meantime, Ottawa would implement its own changes via the route of federal tax credits and 'basic federal tax' would remain unaffected.

Our own preference would be for a committee in which both parties had an equal voice, reflecting the fact that both are engaged in levying taxes on income and both have the constitutional right to do so. We see no reason why such a committee would be inconsistent with the Tax Collection Agreements. Indeed, the opposite is the case. When the provinces sign these five-year 'agreements', surely there must be some presumption that the structure of the tax system cannot be altered dramatically and unilaterally by the federal government.

A 'tax on base' and extended credits

The other option open to the federal government is to increase the provinces' flexibility under the Tax Collection Agreements. The obvious first candidate for this alternative is a move away from the current 'tax on tax' and toward a 'tax on base'. This would allow the provinces to apply their own rate and bracket structures to the common (shared) tax base. There would be some rise in compliance and administrative costs, but computational technology is such that they would not loom large. Obviously, changes in federal tax rates would now have no impact on provincial revenues.

Were this move to be combined with an extension of the credit system, as outlined in alternative 4 of Table 14, the provinces would have an enhanced ability to accommodate any federal changes in the shared base. This proposal would allow the provinces to mount general investment tax credits, but they could not be discriminatory (e.g., Ontario residents would be eligible for any investment credit whether or not the investment took place in Ontario). In our view, it would be difficult for the federal government not to accede to such a proposal, since on occasion it has introduced regional tax credits in its own PIT system. If the federal government has the right to implement such credits, so should the provinces. In general, then, the flexibility associated with such a proposal would diminish the need for joint consultation on the shared base. Once again, there appears to be no reason, in principle, why such changes could not be accommodated under a modified version of the Tax Collection Agreements. As with the existing tax credits, the provinces would be assessed a collection fee. More important, the basic harmony of the system would be left essentially intact.

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[3] *Ibid.*, 414.

[4] *Ibid.*, 416.

Ideally, from the provinces' standpoint at least, this increased flexibility would be combined with some degree of federal-provincial consultation on the underlying structure of the common base.

Why should the federal government make this concession to the provinces? One possible answer, alluded to earlier in the report, is that if Ottawa ignores the provinces' genuine concerns and continues to act as it has in the recent past, it may well preside over the unravelling of the Tax Collection Agreements and the rise of a system of provincial PITs.

A code of economic conduct

However, the Council feels that there must be a *quid pro quo* offered by the provinces. We are very concerned over recent developments in the various provinces that are leading to a fragmentation of the Canadian economic union. Preventing the introduction of tax credits that discriminate against residents of other provinces is not a suitable way to address this issue if provinces are free to implement these measures elsewhere in their fiscal systems. What is required is a 'code of economic conduct' or a 'code of fiscal conduct' wherein all provinces would agree to respect the rights of all Canadians to conduct their economic lives without facing provincially mounted barriers or impediments. We recognize that it is extremely unlikely that all such impediments would be eliminated. Virtually every federal country has in place some sort of preferential purchasing policies at the provincial or state level. Nonetheless, there is a pressing need for guidelines in many areas of action and for some means of implementing them. Ideally, of course, the federal government would also be a party to any such agreement, since it also can and does fragment the internal economic union with various of its policies. To be sure, it would have to be allowed some leeway in order to ensure that such an agreement did not prevent it from making equalization payments, etc.

In principle, there are at least three avenues available for securing an internal economic union.[5] The first of these would be to have the constitution as policeman, as it were. Apart from the fact that the provinces have effectively vetoed this route, the courts are probably not an ideal body to entrust this to. By their very nature, jurisdictional decisions tend to be black or white, yes or no. The courts cannot and should not make positive proposals. Yet what is at stake with respect to this issue does, on occasion, involve compromises and trade-offs. The economic underpinnings are often not clean-cut, and in any event the recent constitutional decisions (e.g., potash and CIGOL) have not demonstrated that the courts have as yet acquired much knowledge and expertise in economic matters.

A second approach would be to have the federal government as policeman. While this may have some benefit *vis-à-vis* the constitution as arbiter in this area, it is probably also a non-starter from the provincial vantage point. Much of the discussion in the constitution debates in the summer of 1980 centred around this possibility. The provincial concerns related to the fact that under such an approach the central government would in effect be preventing the provinces from doing some of the very things that Ottawa was doing!

The Council's preference is for an interprovincial or a federal-provincial umpire. We are encouraged by the fact that at one point or another during the constitutional debates most or all provinces declared themselves in favour of the internal common market. We do not presume to be able to suggest an appropriate structural design for such a committee.[6] However, we would argue strongly that its mandate should encompass much more than the matter of ensuring that the taxation system does not fragment the internal economic union. Matters such as expenditure and purchasing policies as well as regulatory measures, at both levels of government, should be incorporated under the umbrella of any such arrangement.

Thus, it is the Council's view that some version of a code of economic conduct should be part and parcel of a move to increase the flexibility and accommodation of the shared PIT system.

Is it possible, however, that the case for an independent Ontario PIT is so strong that, even in the light of these possible modifications of the present system, it represents a viable alternative?

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[5] For more detail on these three options, see Richard Simeon, 'Alternative Approaches to Securing an Internal Common Market', to be published in the series of background studies relating to this report.

[6] Simeon, *op. cit.*, presents several variants, one or more of which may be worthy of further investigation.

Tables 15 and 16 summarized most of the benefits and costs associated with a move to establish a separate PIT. We do not intend to recapitulate them here. However, in reviewing the potential benefits, it seems to us that the argument for a separate PIT must rest on two premises: (1) that the Ontario economy is structurally different from those of most of the other provinces and, therefore, has different needs as regards the PIT, and (2) that the federal PIT has to be uniform across all jurisdictions and so by its very nature is unlikely to be able to cater to the specific needs of the province. However, even if we accept these premises, it remains to be demonstrated that: (1) an Ontario PIT can indeed be effective in achieving the special needs of the province and (2) the costs are not so high as to outweigh the benefits. Most of the analysis in this report was addressed to these latter two issues.

At the outset, one conclusion is obvious. To the extent that a separate PIT, which would only affect one-third of the total PIT revenue realized from Ontario, could be beneficial, it is clear that it would be far more efficacious if the remaining two-thirds of the system were also similarly structured. Unless one assumes that the so-called 'demonstration effects' are very powerful, it is evident that it is in Ontario's interest to attempt to get its desired PIT changes incorporated in the shared common tax base of the existing PIT. In this important sense, a move toward an independent PIT cannot be a first-best strategy for the province in the present environment. Ontario must first ensure that it has utilized to the utmost every avenue for influencing the overall tax structure. In this regard, we believe it to be in Ontario's interest to pursue the proposals we have outlined in the previous sections.

Turning to the issue of whether the desired goals can be achieved through an independent PIT, the answer is, despite the considerable analytic uncertainty that attends the analysis, that they probably can. But in many instances, the benefits can be achieved, or largely achieved, in alternative ways. Some of these alternatives are more certain in terms of their impact and are often far less costly. Moreover, the combination of a tax on base, an improved consultative process, and an extended tax credit system would appear to give Ontario a good deal of what it would gain from an independent PIT, and at much less cost both in terms of compliance and administration and in terms of the interprovincial harmonization problems that a separate Ontario PIT, or more likely a *system* of provincial PITs, might generate. In this sense, too, the preferable route for Ontario lies in the direction of seeking alternatives within, or modifications of, the present Tax Collection Agreements.

If all these avenues are found to be blocked, then one is back to the dual premises with which this section began. It is certainly the case that the economic structure of Ontario is different from that of other provinces. With a large proportion of the country's manufacturing and finance industry, Ontario's competitive concerns are such that whether Ontario taxpayers are on the same footing as Saskatchewan taxpayers may not be as important as whether Ontario taxpayers are on the same footing as taxpayers in the bordering U.S. states. The federal government, in its role as a broker for provincial interests, could conceivably design a tax structure that left Ontario at a disadvantage in terms of its own interests. Faced with such a situation, the province would be required to enact some offsetting policies. Would an independent PIT prove to be a valuable instrument in this case? The evidence is such that we cannot rule out this option. However, we can with more certainty suggest that the province first work through those non-PIT options which would represent less drastic changes to the system and yet achieve some of the same goals.

SCENARIOS WHICH MIGHT PRECIPITATE A PROVINCIAL PIT

Given our general conclusion that, at the present time, Ontario's interest lies in working toward reforming the PIT system rather than striking out on its own, it is useful to conclude this report with a discussion of the various situations under which the province might feel compelled to adopt its own PIT. Three scenarios come to mind:

1. Ontario opts for a separate PIT because it is convinced that it represents an important new set of policy instruments with which to achieve the province's goals.
2. Ontario opts for a PIT as a defensive reaction to overall federal tax policies which are deemed to be prejudicial to Ontario interests and therefore should not be magnified by binding the Ontario portion of the PIT.
3. Ontario opts for a PIT as a defensive reaction to the separate PITs of other provinces or as a defensive reaction to province-building policies enacted by other provinces.

Option 1 may provide a rationale for a separate PIT over the longer term, but, as we have pointed out on several occasions, it is not the appropriate policy at the present time. There are simply too many alternative avenues that would have to be exhausted before opting for a separate PIT would be in Ontario's interest.

Option 2 is far more likely to precipitate action by Ontario. We believe that the federal government has been rather cavalier in its approach to the shared component of the joint PIT. Nonetheless, the Tax Collection Agreements have been a valuable and unique innovation in the evolution of intergovernmental fiscal relations. Moreover, on more than one occasion, they have proved to be flexible enough to accommodate the changing needs of both the federal government and the provinces. We have outlined several alternative proposals for modifying the present arrangements in a manner that is likely to satisfy both partners. We believe that there is much to be gained by all Canadians, and therefore by the federal government, if some acceptable form of the Tax Collection Agreements can be maintained.

The final rationale for a separate Ontario PIT is also a real possibility. In part, it relates to the second option, since the process has to start with one province deciding to go it alone on the PIT. In part, also, it relates to the ongoing tendency of the provinces to embark on provincial development strategies, some of which are 'province-first' in nature. Our approach to this general issue has been to argue for the preservation of the internal common market. We commend the present approach whereby tax credits that fragment the economic union are, in general, not permitted under the Tax Collection Agreements. But this does not go far enough—little is gained in terms of promoting interprovincial commerce and mobility if these impediments crop up outside the tax system. Thus, the Council has come to the view that it is appropriate and essential that the federal government and the provinces hammer out a code of economic conduct across the entire fiscal front that will guarantee to Canadians the right to move, work, save, and invest freely in any part of the federation.

In addressing these three reasons why Ontario might adopt its own PIT, the Council has effectively summarized its position with respect to the Reference:

—A separate PIT is not in the immediate interests of the Province of Ontario. There are simply too many alternative options yet open to the province to justify such a move.

—Ontario should, in general, strive to rekindle the spirit of cooperative, consultative federalism and, in particular, strive to bring this spirit of cooperation and consultation to the Tax Collection Agreements that have served Ontario and Canada so well in the past.

—These Tax Collection Agreements should be modified in the direction of providing the provinces with more freedom, short of adopting discriminatory measures, to adjust to federal changes that may not be in their individual or collective interests.

—Canada needs a code of economic or fiscal conduct in order to promote internal economic union.

All that remains is for us to formalize these conclusions in a set of recommendations.

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Recommendations

The Council recommends that the Province of Ontario not move toward a separate PIT at this time. It is not the first-best strategy to adopt in terms of dealing with the many concerns the province may have about the shared PIT. Nonetheless, the Council recognizes that Ontario, or other provinces, could be forced into the position of designing and implementing their own PITs in the event that unilateral federal changes to the personal taxation system are deemed to be prejudicial to provincial interests. The Council believes that it is imperative that this situation not come to pass.

Accordingly, the Council recommends that the federal government and the provinces recognize the serious nature of the course of action that they have been following over the past few years in terms of its implications for tax harmony and the preservation of the internal economic union, and that they work together to accommodate their interests within the framework of a modified Tax Collection Agreement. In particular, the Council recommends that the following items are deserving of further exploration:

—A federal-provincial tax structure committee which would allow joint input into the determination of the common tax base.

—A move toward a 'tax on base' as opposed to the present 'tax on tax' system.

—An extension of the tax credit system to provide the province with more freedom to implement non-discriminatory measures within their portion of the joint PIT.

—The establishment of a 'code of economic conduct' which will ensure that the internal economic union is preserved not only within the tax system but across the entire fiscal and regulatory front.

The Council recommends that the Province of Ontario, probably in the person of the Treasurer, take the initiative in these areas.

In terms of the immediate future, the Council notes that the federal government will presently introduce legislation with respect to the personal income tax treatment of inflation. We have described this elsewhere as one of the most fundamental reforms in the PIT in the post-war period. Moreover, the federal Department of

Finance is undertaking a study relating to the manner in which business income and personal investment income might be adjusted for the inflation component of any income. The Council recommends that Ontario become as involved as the process will allow in this restructuring of both the personal and corporate income tax systems of the nation. It represents an opportunity for the province to impress upon the federal authorities its particular concerns relating to the structure and evolution of the personal income taxation system in Canada. Moreover, it represents a unique opportunity for the Government of Canada to involve the provinces in the restructuring of what, after all, is also their own tax system and in this way to begin the process of restoring the spirit of cooperation and consultation that was once associated with the Tax Collection Agreements.

Contributors to background study

Richard Bird, Professor, Department of Economics, and Director, Institute for Policy Analysis, University of Toronto.

Robin Boadway, Chairman, Department of Economics, Queen's University, Kingston, Ontario.

Neil Bruce, Professor, Department of Economics, Queen's University, Kingston, Ontario.

Sam Bucovetsky, Professor, Department of Economics, University of Western Ontario, London, Ontario.

Douglas Crocker, Economist, Ontario Economic Council.

Peter Dungan, Associate of the Institute for Policy Analysis, University of Toronto.

Frank Flatters, Professor, Department of Economics, Queen's University, Kingston, Ontario.

Claude Forget, Visiting Professor, McGill University, Montreal, Quebec.

Douglas Hartle, Professor, Department of Economics and Associate of the Institute for Policy Analysis, University of Toronto, and Consultant, Ontario Economic Council.

Ronald Hood, Grady Economics and Associates Ltd., Ottawa, Ontario.

Edwin Neave, Professor, School of Business, Queen's University, Kingston, Ontario.

Peter Quance, Consultant, Ontario Economic Council.

Peter Ross, Grady Economics and Associates Ltd., Ottawa, Ontario.

Samuel Rea Jr., Professor, Department of Economics, University of Toronto.

Richard Simeon, Director, Institute of Intergovernmental Relations, Queen's University, Kingston, Ontario.

Enid Slack, Enid Slack Consulting Inc., and Consultant, Ontario Economic Council.

Wayne Thirsk, Professor, Department of Economics, University of Waterloo, Waterloo, Ontario.

John Thompson, National Tax Partner, Coopers & Lybrand, Chartered Accountants, Toronto.

John Todd, President, Ecoanalysis Consulting Services Inc., Toronto.

Sandra Tychsen, Economist, Ontario Economic Council.

Thomas Wilson, Chairman, Department of Economics, University of Toronto.